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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

HERITAGE CAPITAL CORPORATION; NORTH RIVERSIDE VENTURE, INC.; AND VENTURTECH II, LIMITED PARTNERSHIP,

Petitioners,

v.

DELOITTE, HASKINS & SELLS,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fourth Circuit

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PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does a showing of recklessness satisfy the scienter requirement of the federal laws proscribing securities fraud?

2. Does a public accounting firm which makes affirmative representations about the financial position of a securities issuer have a duty under the federal securities laws not to act recklessly in making those representations, and does that duty extend to all those whom the accounting firm knew, or should have known, would rely on those representations?

PARTIES TO THE PROCEEDINGS IN THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioners and Respondent were the sole parties in the United States Court of Appeals proceedings.

Petitioner Heritage Capital Corporation is wholly owned by R.S. Dickson and Co., a subsidiary of the Ruddick Corporation.

Petitioner North Riverside Venture, Inc. is wholly owned by North Riverside Holdings, Inc., a subsidiary of Eagle Industries, Inc., which is wholly owned by Great American Management & Investment, Inc.

Petitioner Venturtech II, Limited Partnership has no parent or subsidiary company to be listed.

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PETITION FOR WRIT OF CERTIORARI

Petitioners respectfully request that a writ of certiorari issue to review the decisions by the United States Court of Appeals for the Fourth Circuit and the United States District Court for the Eastern District of North Carolina, Raleigh Division, in this case.

OPINIONS BELOW

The trial court rendered two dispositive decisions

relevant to this petition. The first decision is reported as *Venturtech II, Limited Partnership v. Deloitte, Haskins & Sells*, 790 F. Supp. 576 (E.D.N.C. 1992); the second decision is not reported.[1] The United States Court of Appeals for the Fourth Circuit affirmed per curiam.

The trial court granted summary judgment to Defendant on the merits of all claims in the two separate orders. In the first, rendered April 2, 1992, the trial court found no substantial evidence to support any of Petitioners' negligent misrepresentation, breach of third party contract, and securities fraud claims under North Carolina law, and granted Defendant's motion for summary judgment while denying Petitioners' motion for partial summary judgment. In the second, rendered May 15, 1992, the trial court entered an order granting Defendant summary judgment as to all federal securities fraud claims.

The United States Court of Appeals for the Fourth Circuit affirmed these decisions on April 30, 1993. The Court of Appeals issued its mandate on May 21, 1993.

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[1] The trial court entered three other orders regarding Petitioners' section 10(b) claims, which are not relevant to this appeal. These three orders addressed the timeliness of Petitioners' claims, after this Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. ___, 111 S.Ct. 2773 (1991). The trial court initially dismissed Petitioners' section 10(b) claims as untimely in an order dated October 3, 1991, and then reinstated those claims in an order dated February 3, 1992, based upon § 476 of the Federal Deposit Insurance Corporation Improvement Act of 1991, 15 U.S.C. § 78aa-1. Upon its own motion for reconsideration, the trial court affirmed its February 3, 1992 order reinstating the claims. The latter decision is reported at *Venturtech II, Limited Partnership v. Deloitte, Haskins & Sells*, 790 F.Supp 574 (E.D.N.C. 1992).

STATEMENT OF JURISDICTION

Petitioners' complaint raises securities fraud claims under section 10(b) of the Securities Exchange Act of 1934, supported by federal question jurisdiction under 28 U.S.C. § 1331; together with supplementary state law claims.

This petition is timely, filed within 90 days of the decision by the Court of Appeals. This Court has certiorari jurisdiction pursuant to 28 U.S.C. § 1254.

FEDERAL STATUTE INVOKED

15 U.S.C. § 78j(b) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . .
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

STATEMENT OF THE CASE

The following facts are derived from the summary judgment record. They present two issues meriting this Court's review: (1) does a public accountant's recklessness satisfy the scienter requirement of the federal securities laws; and (2) what is the "knowledge" and "substantial assistance" that will render

a public accountant liable for violations of the federal securities laws?

Petitioners are venture capital firms which invested in Learning Resources, Incorporated ("LRI") by purchasing stock. In making their investment decisions, petitioners relied upon LRI's financial statements audited by the defendant, Deloitte, Haskins & Sells ("Deloitte"). Petitioners North Riverside and Heritage invested in LRI on December 31, 1986. The audits upon which they relied were those for fiscal years 1985 and earlier. Petitioner Venturtech invested in the spring of 1987, after issuance of the 1986 audit. Venturtech deliberately awaited the results of the 1986 audit before deciding whether to invest in LRI.

Deloitte is a prominent international accounting firm. It became LRI's auditor in 1981, and remained LRI's auditor from year to year. As part of the audited financial statements, Deloitte affirmatively represented, in its own unqualified opinions, that the audits of LRI's financial statements were made in accordance with generally accepted auditing standards ("GAAS"), and that LRI's financial statements fairly presented LRI's financial position in conformity with generally accepted accounting principles ("GAAP").

LRI was a small, emerging firm in the unique business of video publishing, located in North Carolina's Research Triangle Park. LRI posed greater risks than traditional investors were willing to bear, and depended upon venture capital for its financing.[2] At

[2] The United States government has recognized the importance of venture type capital financing by enacting the Small Business Investment Act, 15 U.S.C. § 681 et seq. Petitioner North Riverside operates a small business investment company licensed under this statute.

regular and consistent junctures in its history, LRI successfully solicited venture capital to keep itself afloat and expand. LRI's stock was not registered, but the capital markets it targeted during its solicitations were nationwide.[3] The primary documents used in these solicitations were LRI's own business plans, and the financial statements audited by Deloitte.

Deloitte knew of LRI's capital raising efforts through, among other things, its intimate contact with LRI's small staff during the annual audit processes; its discussions with LRI's officers about the company's business, a required annual audit procedure; its review of LRI's board minutes; and its review of LRI's financial records, which reflected repeated and regular infusion of investment capital. Experience with an early venture capital investor in LRI taught Deloitte that a venture capitalist would rely on Deloitte's work in making an investment decision. In an internal memorandum dated September 30, 1982, a Deloitte auditor noted that LRI was in the process of negotiating a venture capital deal, and that Deloitte's review report would be relied upon during those negotiations.

By late 1986, Deloitte knew specifically about the solicitation by LRI of Petitioners' investments. Board minutes reviewed during the course of the 1986 audit revealed to Deloitte that six venture capital firms were considering an investment in LRI. Furthermore, board minutes disclosed the fact that two of the Petitioners, Heritage and North Riverside, had submitted a "term sheet" outlining an investment pro-

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[3] Venture capital firms from Massachusetts, Georgia, North Carolina, Alabama and New Jersey purchased LRI stock.

posal. In an internal audit planning memorandum regarding the 1986 audit, entitled "Special Audit Risk Narrative to Affirmative Answers" (significantly, attached to Deloitte's "Special Audit Risk Questionnaire"), a Deloitte auditor noted that LRI anticipated issuing approximately $750,000 of Class B preferred stock prior to December 31, 1986. In a similar audit planning memorandum, entitled "Discussions with Client Personnel," a Deloitte auditor noted that LRI hoped to raise approximately $750,000 in capital by issuing Class B preferred stock prior to December 31, 1986 to *new* investors. (emphasis in original). Minutes from a Board meeting held March 5, 1987 revealed that LRI continued to solicit venture capital—specifically from Petitioner Venturtech—during early 1987.

Although Petitioners' complaint pointed to a host of unexplained audit failures, it called special attention to two gross, and effectively undisputed, errors in the 1986 audit, and one in the 1985 audit. First, during both the 1985 and 1986 audits, Deloitte, in violation of every recognized standard of auditing practice, failed to obtain written representations from LRI's management regarding the accuracy of the financial information included in the financial statements. Written management representations regarding either the 1985 or the 1986 financial statements simply do not exist. In contrast, prior to 1985, Deloitte had obtained written representations from LRI's chief executive officer and chief financial officer during each annual audit. Perhaps most compellingly, both LRI's chief executive officer and its chief financial officer, the two officers whom Deloitte should have asked to provide these representations, explicitly

denied providing such representations in connection with the 1986 audit. In fact, both officers testified they would not have provided the representations had they been asked to do so.[4]

Auditing standards require the auditor to qualify its opinion if management refuses to furnish written representations. Deloitte recklessly rendered unqualified opinions about LRI's 1985 and 1986 financial statements, despite the absence of management representations. Had Deloitte's opinions been qualified, none of Petitioners would have invested.

These audit failures were not merely technical. As a practical matter, auditors cannot investigate every bit of financial information included in financial statements. Necessarily, in formulating their opinion that the financial statements present fairly the company's financial position in conformity with GAAP, they depend on management's representations that the financial information is accurate. Absent such representations from management, the auditor's own opinion is incorrect. Moreover, the auditor alone effectively assumes responsibility for the accuracy and reliability of the financial information, because no one else, not even the audited company's officers, has vouched for it.

As a second gross error, in 1986 LRI counted as an asset a purported receivable from the University of North Carolina ("UNC"). This single receivable was by far the largest included in LRI's balance sheet. It was nearly twice the next largest receivable, and four

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[4] The officers provided vague testimony about the 1985 representations; neither testified they provided representations in 1985, and no written representations exist in Deloitte's or LRI's files.

times the third largest receivable. It accounted for some 10% of LRI's total reported receivables. Despite its magnitude, and in violation of GAAS, Deloitte did not test the legitimacy of the UNC receivable. In fact, LRI had no contract with UNC during its fiscal year 1986, and, therefore, no receivable from UNC, a fact Deloitte would have uncovered if it had performed basic audit procedures. This GAAS audit failure thus lead to a GAAP financial reporting failure: the inclusion of this receivable as an asset on LRI's 1986 balance sheet.

Deloitte's audit failure might be considered merely negligent had it simply overlooked the purported UNC receivable. But Deloitte had special knowledge about LRI's relationship with UNC which made it reckless to decide not to investigate the receivable. The financial reporting of this relationship had been mishandled by LRI in the past. In 1982 Deloitte required LRI to make a substantial adjustment to its 1981 balance sheet, primarily due to LRI's misstatement of the UNC receivable. LRI's chief executive officer, who was responsible for the misstatement in 1981, was LRI's chief executive officer in 1986. The Deloitte auditor who uncovered the error in 1981 was the partner in charge of the 1986 audit. Deloitte knew that the contract between UNC and LRI which had begun in 1981 was due to expire in 1986. Inexplicably, Deloitte declined to investigate whether the contract had been renewed in 1986. In fact, it had not been renewed; yet LRI recorded it anyway.

These—and other—audit failures resulted in misrepresentations not only in LRI's financial statements, but, more importantly, in Deloitte's unqualified

opinions regarding those financial statements. LRI's audited financial statements depicted a growing, successful company whose profits were generally steady or increasing each year. According to the audited financial statements, profits peaked at nearly a quarter of a million dollars in 1985 and 1986. These financial statements were misleading, particularly with regard to LRI's profitability. Petitioners invested in reliance on those misrepresentations. Less than a year after Petitioner Venturtech's investment, LRI was bankrupt, and Petitioners lost virtually their entire investments in LRI, over one million dollars. This lawsuit followed.

REASONS FOR GRANTING THE WRIT

This action poses a substantial issue: are public accountants liable for federal securities fraud to private investors, when the accountants should know that the investors will rely on the accountants' reckless, affirmative misrepresentations? The trial court (and, by affirming without opinion, the Fourth Circuit Court of Appeals) reached two conclusions which reflect the inconsistent approaches federal courts have taken toward accountants' liability. The trial court held that this public accounting firm had no duty to these investor Petitioners because it did not have specific knowledge that these specific investors would rely on specific audits when making specific investment decisions, adopting essentially a privity standard for public accountants' liability. Having concluded that this public accounting firm had no duty, the trial court held that evidence that this accounting firm recklessly made its own misrepresentations about the audited company was insufficient, as a matter of law, to es-

tablish scienter under the federal securities laws. These are undesirable conclusions. They minimize the responsibilities of public accountants. Particularly in the nonregistered, national capital markets at issue here, where accountants serve as the primary public safeguard of financial information, these responsibilities should not be minimized.

Moreover, these decisions conflict with decisions by courts which have found that accountants who make affirmative representations about securities issuers have a duty to investors under the securities laws, and that recklessness is sufficient to establish liability. Since this Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), there has been substantial controversy regarding the scienter element in federal securities cases, particularly as it applies to public accountants. Footnote twelve of the *Hochfelder* opinion left open the possibility of imposing civil liability for reckless conduct in section 10(b) actions. *Id.* at 193 n.12. Subsequently, the courts have rendered conflicting decisions regarding the relevance of recklessness to section 10(b) lawsuits.[5] This petition seeks to

[5] A sampling of decisions reveals the widely differing approaches to this issue. For example, courts in the Third Circuit have held that recklessness may satisfy the scienter requirement. *E.g.*, *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Wiley v. Hughes Capital Corp.*, 746 F. Supp. 1264, 1283 (D.N.J. 1990). On the other hand, the Eighth Circuit has held that recklessness alone is not sufficient. *E.g.*, *Stokes v. Lokken*, 644 F.2d 779, 784 (8th Cir. 1981). Meanwhile, courts in the Second Circuit have held that recklessness satisfies the scienter requirement only if the defendant owes a fiduciary duty to the defrauded party. *E.g.*, *Goodridge v. Harvey Group, Inc.*, 778 F. Supp. 115, 126 (S.D.N.Y. 1991); *Varnberg v. Minnick*, 760 F. Supp. 315, 331 (S.D.N.Y. 1991).

resolve the ambiguity which remains from footnote twelve, and to standardize the requirements for accountants' liability under section 10(b).

The federal securities laws and public policy demand that public accounting firms be held responsible for reckless conduct which impacts investors whom the accounting firm knows, or should know, are relying on its work. Action by this Court is needed in order to create uniformity in this inharmonious and important area of the law.

This case is about an accounting firm's own failures to live up to its own responsibilities under section 10(b). This is not a case where the defendant did nothing but watch silently while another violated the securities laws. The public accountant's job is to *test* financial statements in accordance with community standards of care, and then render its *own* opinions regarding the fairness of those financial statements. Petitioners presented substantial evidence that Deloitte itself made—recklessly—affirmative misrepresentations about the financial condition of a securities issuer, knowing the issuer was soliciting investors.

This Court has characterized the role of auditors as a public function, carrying public responsibilities:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watch-

> dog" function . . . requires complete fidelity to the public trust.

United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984) (emphasis in original).

The Courts of Appeal for the Fifth and Eleventh Circuits have made it very clear that public accountants are among those who have special obligations to investors. *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043-44 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 n.28 (5th Cir. 1975) ("A duty of disclosure may exist where any person possesses inside information, or where the law imposes special obligations, as for accountants . . . ."). This is because accountants obtain information during the audit process which generally is unavailable, as an actual or practical matter, to potential investors. The *Rudolph* court emphasized:

> It is not unreasonable to expect an accountant, who stands in a "special relationship of trust vis-a-vis the public," . . . and whose "duty is to safeguard the public interest," . . . to disclose fraud in this type of circumstance, where the accountant's information is obviously superior to that of the investor, the cost to the accountant of revealing the information minimal, and the cost to investors of the information remaining secret potentially enormous.

Rudolph, 800 F.2d at 1044-45 (quoting *Gold v. DCL, Inc.*, 399 F. Supp. 1123, 1127 (S.D.N.Y. 1973) and *Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 670 (1957)) (footnotes omitted). This "public watchdog"

function should be emphasized, not minimized, in circumstances where accountants make affirmative misrepresentations, as Deloitte did here. Yet, the trial court and Fourth Circuit found that this public accounting firm had no duty whatsoever to these investors.

Accountants who audit companies which issue securities are subject to claims of primary violation of the Securities Exchange Act. *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). It should be fundamental that accountants are responsible under section 10(b) for their own misrepresentations. *See, e.g., Sioux, Ltd. Sec. Litig. v. Coopers & Lybrand*, 914 F.2d 61, 64-66 (5th Cir. 1990); *cf. Schatz v Rosenberg*, 943 F.2d 485, 491 (4th Cir. 1991), *cert. denied*, 503 U.S. ___, 112 S.Ct. 1475 (1992) (lawyer had no section 10(b) duty to disclose *client* misrepresentations, expressly distinguishing decisions holding professionals liable for issuing their *own* reckless or misleading opinions) (*citing T.J. Raney & Sons, Inc. v. Fort Cobb Okla. Irr. Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983), *cert. denied*, 465 U.S. 1026 (1984); *Cronin v. Midwestern Okla. Dev. Auth.*, 619 F.2d 856 (10th Cir. 1980)). The trial court and Fourth Circuit in the case at bar rendered decisions inconsistent with this basic premise.

The trial court ruled that Deloitte could be held liable for a primary violation for reckless conduct only if Deloitte had an independent duty to disclose apart from the duties imposed by section 10(b). However, the Courts of Appeal decisions cited by the district court do not support a "separate duty" limitation upon the recklessness standard. In particular, *Akin v. Q-L Investments, Inc.*, 959 F.2d 521 (5th Cir. 1992)

and *Camp v. Dema*, 948 F.2d 455 (8th Cir. 1991), deal with the role of recklessness in establishing "knowledge" of another's primary violation, for purposes of establishing secondary liability under the Act. Neither decision affects Deloitte's primary liability.

The trial court erroneously relied upon *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), *cert. denied*, 503 U.S. ___ (1992), as somehow controlling the issue of the requisite mental state for primary violations of section 10(b). But nowhere does *Schatz* address any potential distinction between recklessness and scienter. *Schatz* dealt solely with the issue of whether the lawyer-defendant in that case had a duty to disclose its client's misrepresentations. When the defendant makes its own misrepresentations, the issue of a separate duty to disclose someone else's misrepresentations is irrelevant.

In *Schatz*, the court did impose a "separate duty" prerequisite to section 10(b) liability in the context of a professional's *silence*, that is, an attorney's failure to disclose information relayed to him in confidence by his client. *Id.* at 490. But the functions of the public auditor and those of the lawyer are markedly different. A lawyer's primary duty is the private duty to the client, often frequently demanding nondisclosure. A public accountant, however, which makes affirmative representations based upon its own work, has a duty to make sure that its representations are not misleading. The decisions by the trial court and the Fourth Circuit in this case recognize no such duty.

The trial court also dismissed Petitioners' claims of secondary liability for violations of section 10(b). The trial court granted summary judgment on precisely the same ground that it dismissed Petitioners' pri-

mary liability claims. It concluded that Deloitte owed Petitioners no duty, hence was not liable as an aider and abettor because it lacked the requisite mental state to violate, or assist in the violation of, section 10(b).

Accountants are liable under section 10(b) not only for primary violations, but also for aiding and abetting the primary violations of others.

> [T]he following three elements . . . establish an aiding and abetting securities violation: (1) a primary violation by another person; (2) the aider and abettor's "knowledge" of the primary violation; and (3) "substantial assistance" by the aider and abettor in the achievement or consummation of the primary violation.

Schatz v. Rosenberg, 943 F.2d at 495.

The decisions of the various Courts of Appeal are split on how to apply the second and third elements to public accountants. This is precisely the reason why this case merits review by this Court. The superior standard is: "An accountant may be liable as an aider and abettor if it knows, or is reckless in not knowing, that its client has committed a primary violation, and it substantially aids the client in the overall enterprise." *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1312 (9th Cir. 1982). Even compliance with GAAS and GAAP did not immunize the accountant in *Admiralty Fund* against aider and abettor liability. *Admiralty Fund*, 677 F.2d at 1313 n.13. Deloitte's conduct of the 1985 and 1986 audits was reckless, and substantially aided LRI's primary violation, within the meaning of *Admiralty Fund*.

The decisions holding that professionals have no duty to act as whistle blowers, including *Schatz*, are irrelevant where the lawyer or accountant steps from the sidelines and becomes actively involved in the representations. *Morgan v. Prudential Group, Inc.*, 527 F. Supp. 957, 960-61 (S.D.N.Y. 1981), *aff'd*, 729 F.2d 1443 (2d Cir. 1983) (attorney liable); *e.g. First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891, 903 (10th Cir. 1992), *cert. granted in part sub nom., Central Bank of Denver v. First Interstate Bank of Denver*, 1992 WL 353244 (U.S.)[6] ("in an aiding-and-abetting case based on assistance by action, the scienter element is satisfied by recklessness"); *cf. In re Gas Reclamation, Inc. Sec. Litig.*, 659 F. Supp. 493, 506 (S.D.N.Y. 1987) (accountant has "no duty to . . . investors absent an affirmative representation"). Deloitte made its own misrepresentations here, recklessly issuing its opinions regarding the financial condition of LRI without the support of the company's management.

In *Pring*, one of the Defendants, Central Bank, made the argument—essentially the same argument made by Deloitte—that recklessness is not sufficient scienter where there is no duty to disclose. The Tenth Circuit, however, took a broader view. That court "reject[ed] the idea that the scienter element for aid-

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[6] This Court granted certiorari in part in *Pring* on June 7, 1993. This Court directed the parties to address the following question: "Whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5." *Central Bank of Denver v. First Interstate Bank of Denver*, 1992 WL 353244 (U.S.). The petition here raises issues of accountants' primary responsibilities as well as secondary responsibilities.

ing-and-abetting liability cannot be satisfied by recklessness without a duty to disclose" and held that the scienter element was satisfied by a showing of recklessness. *Pring*, 969 F.2d at 903; *see also Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 660 F. Supp. 1362, 1367 (D. Conn. 1987) ("The existence of a fiduciary duty, however, is not a prerequisite for the application of the recklessness standard to satisfy the knowledge element of an aiding and abetting claim under the securities laws.")

This duty to avoid reckless conduct arises in cases of foreseeable investor reliance, and thus exists beyond doubt where the accountant has prepared an opinion for publication in a formal prospectus. *Rudolph v. Arthur Andersen & Co.*, 800 F.2d at 1043-45 (accountant's duty to correct misleading opinions included in securities prospectus). Additionally, the duty arises when the accountant is explicitly informed that its review will be used as part of a securities transaction. *Ades v. Deloitte & Touche*, 799 F. Supp. 1493 (S.D.N.Y. 1992). The accountant's duty for securities law purposes is equally clear where other circumstances make investor reliance foreseeable. *See, e.g., Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1012 (11th Cir. 1985) (bank liable even though bank officer's "communication did not reach the actual investors, [because] it was foreseeably relied upon by the trustee bank that was to hold the investors' money"); *Axel Johnson, Inc. v. Arthur Andersen & Co.*, 762 F. Supp. 599 (S.D.N.Y. 1991) (facts put auditor on notice of likely sale of client); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1334-35 (S.D.N.Y. 1982) (auditor on notice of likely securities transactions because of audits

of related investor and investment vehicle). The same duty to avoid reckless conduct should extend in circumstances such as those presented by this case.

The trial court here applied a different, contradictory analysis. The trial court decided that this accountant defendant had no duty whatsoever to these Petitioners. Its rationale was that the accounting firm had no knowledge of Petitioners' reliance. But there was evidence of knowledge. LRI solicited venture capital annually; not enough money had been raised in 1986, so the solicitation would continue during 1987 (while the 1986 audit was being performed); and past experience showed that one venture capitalist relied on Deloitte's work in connection with an investment decision. The trial court essentially imposed a privity standard on an accountant's duty under the federal securities laws: unless the accountant has specific knowledge of a specific venture capitalist's reliance on a specific audit, the accountant has no duty, even if the accountant knows that capital will be solicited and its work will play a role in that solicitation.

The trial court's analysis is incorrect and publicly undesirable, both as an interpretation of existing precedent and as a practical matter. The trial court ignored the reality that audits are performed only once a year but used throughout the year, with the auditor's knowledge and acquiescence. Petitioners have never argued that the auditor's responsibility should extend to any use by any user. Where there is no pattern of use of client audits for a specific purpose, a duty may never arise. Where a pattern becomes stale, a duty may end. Here, by way of contrast, Deloitte knew that LRI consistently sought venture capital over a period of years, up to and including

the years of the audits upon which Petitioners sue. When year after year the same use is made by a limited group, responsibility should attach.

The trial court obviously misinterpreted the "knowledge" requirement to mean "contemporaneous notice" during each audit. This interpretation gives accountants a means to circumvent the knowledge requirement because, in the absence of privity or a formal prospectus which the accountant helped prepare, there are virtually no circumstances in the regular course of business in which an accountant would have contemporaneous notice.

Knowledge and notice clearly are different requirements. A defendant may very well know facts, even if it is not specifically notified of those facts at a specific time. Contrary to the trial court's analysis, knowledge does not disappear when the calendar flips to a new year. Knowledge is an accumulation of facts learned at any time and from any source. And knowledge, like any other state of mind hidden from observation, can, and often must, be established circumstantially. *See, e.g., American Communications Ass'n, C.I.O. v. Douds*, 339 U.S. 382, 411 (1950).

Moreover, the district court's holding that Deloitte had no duty ignores a central relevant fact in this lawsuit. Deloitte failed to take one simple step required by the standards of its profession in order to maintain a professional distance from the representations in LRI's financial statements. Deloitte failed to obtain management representation letters regarding the accuracy of LRI's financial statements during both the 1985 and the 1986 audits. Because only Deloitte vouched for the financial statements' accuracy, Deloitte made those statements its own representa-

tions of fact. Thus, it assumed a duty by stepping outside its normal professional role. Deloitte cannot hide behind any assurances of correctness from management, because it simply failed to obtain the required assurances. Nor can Deloitte claim that it merely presented financial information for which LRI's management had ultimate responsibility. LRI's management did not take responsibility for this financial information, yet Deloitte rendered its opinions. By representing the facts on its own hook, knowing of LRI's use of its audit opinions in soliciting venture capital, Deloitte assumed a duty toward Petitioners for federal securities fraud purposes.

Participation in a securities transaction carries with it a correlative duty to avoid reckless representations or omissions. *E.g., Van Dyke v. Coburn Enterprises, Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989); *Eisenberg v. Gagnon*, 766 F.2d 770, 777 (3d Cir. 1985). Deloitte did not solicit these investments; nor did it help create a formal, published prospectus including its name and work. Deloitte nevertheless participated—knowingly—in these securities transactions. Deloitte knew that LRI consistently and regularly solicited capital from nationally active professional investors in small, emerging businesses. Deloitte knew specifically that LRI intended to solicit capital during 1986 and 1987. Accurate, dependable financial information is as important in this financial context as it is in public offerings. Deloitte knew that potential investors would depend on audited financial information. As LRI's auditor, it had a duty to those potential investors.

Furthermore, when it failed to obtain proper management representations of accuracy, Deloitte stepped out of its independent, professional role, and became

the primary proponent of the truthfulness of LRI's financial statements. No duty is being thrust upon Deloitte to disclose information withheld. Deloitte undertook its own duty to present accurately the information it *actually* disclosed.

Deloitte's misrepresentations were reckless. As several of the Courts of Appeal have held, recklessness should be the required scienter for primary violations of section 10(b). *E.g., Van Dyke v. Coburn Enters., Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989) (collecting decisions); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-24 (6th Cir. 1979) (collecting decisions); *see also Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977) (adopting a matching "recklessness" standard for judging the due diligence of securities fraud plaintiffs).

> Drawing upon the analogy between the § 10(b)/Rule 10b-5 claim and common law fraud, it is appropriate to hold that recklessness constitutes sufficient scienter for both.
>
> * * *
>
> Requiring a plaintiff to show that the defendant acted with actual subjective intent to defraud could impose a great burden upon recovery, greatly limiting the § 10(b)/Rule 10b-5 claim . . . .

Mansbach, 598 F.2d at 1024-25. The Court of Appeals for the Tenth Circuit echoed the language of *Mansbach* in *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982). In contrast, the decisions by the courts in this action overlook all evidence of reck-

lessness, concluding instead that Deloitte had no duty at all.

Any remaining doubt whatsoever about the nature of Deloitte's conduct is dispelled by a remarkably similar recent decision against the same Defendant. *Ades v. Deloitte & Touche*, 799 F. Supp. 1493 (S.D.N.Y. 1992). The *Ades* court found sufficient basis for a claim of primary and secondary liability premised on reckless disregard. In *Ades*, the investors alleged that Deloitte certified the accounts receivable of a client, but failed to test two "receivables" so substantial in size as to affect the profit-and-loss position of the client, when Deloitte was on notice of facts that cast doubt on the existence of those receivables. *Id.* at 1498-1500. The factual similarities of these cases, coupled with their contradictory results, accentuate the need for this Court to bring uniformity to this area of the law.

CONCLUSION

The federal securities laws and public policy demand that public accountants be held liable for their reckless conduct. Moreover, the current inconsistency in the Courts of Appeal, regarding the duty and scienter elements in federal securities cases, warrants certiorari by this Court.

This 29th day of July, 1993.

Respectfully submitted,

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Limited Partnership

APPENDIX

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 92-1788

HERITAGE CAPITAL CORPORATION; NORTH RIVERSIDE VENTURE, INCORPORATED; VENTURTECH II, LIMITED PARTNERSHIP,

Plaintiffs-Appellants,

v.

DELOITTE, HASKINS & SELLS,

Defendant & Third Party Plaintiff-Appellee,

v.

LEARNING RESOURCES, INCORPORATED; KITTY HAWK CAPITAL, INCORPORATED; CHRISTOPHER W. HEGELE; ROBERT L. CHAPMAN; THOMAS BARRY; GREYLOCK PARTNERS AND COMPANY; ADVANCED TECHNOLOGY DEVELOPMENT FUND; DAVID L. STROHM; RONALD W. WHITE,

Third Party Defendants.

Appeal from the United States District Court
for the Eastern District of North Carolina, at Raleigh.
Malcolm J. Howard, District Judge.
(CA-88-1012-5)

Argued: April 1, 1993

Decided: April 30, 1993

Before RUSSELL and WILLIAMS, Circuit Judges, and SPROUSE, Senior Circuit Judge.

Affirmed by unpublished per curiam opinion.

COUNSEL

ARGUED: William Emslie Sumner, SUMNER & HEWES, Atlanta, Georgia, for Appellants. James Thomas Williams, Jr., BROOKS, PIERCE, MCLENDON, HUMPHREY & LEONARD, Greensboro, North Carolina, for Appellee. **ON BRIEF:** Stephen J. Anderson, SUMNER & HEWES, Atlanta, Georgia; Thomas A. Farr, MAUPIN, TAYLOR, ELLIS & ADAMS, P.A.,Raleigh, North Carolina, for Appellants. Jeffrey E. Oleynik, Daniel M. Sroka, BROOKS, PIERCE, MCLENDON, HUMPHREY & LEONARD, Greensboro, North Carolina, for Appellee.

Unpublished opinions are not binding precedent in this circuit. See I.O.P. 36.5 and 36.6.

OPINION

PER CURIAM:

Heritage Capital Corp., Northside Riverside Venture, Inc., and Venturtech II, Ltd., filed an action in federal court alleging claims under North Carolina law for common law fraud, negligent misrepresentations and breach of contract. Plaintiffs also alleged violations of federal and state securities laws. The allegations centered around Learning Resources Inc.'s (LRI) financial statements, which were audited by the Defendant, Deloitte, Haskins and Sells. Plaintiffs had invested substantial venture capital in LRI and alleged that they had done so in reliance on the audited financial statements which contained material misrepresentations and inaccuracies.

The district court granted DH&S's motions for summary judgment on all Plaintiffs's claims in two separate orders. In its April 1 Order, the district court granted summary judgment to DH&S and denied Plaintiffs's motion for summary judgment on Plaintiff's breach of contract and negligent misrepresentation claims. *Venturtech II, Ltd. v. Deloitte, Haskins & Sells,* 790 F. Supp. 576, 581-86 (E.D.N.C. 1992). The district court also granted DH&S's motion for summary judgment on Plaintiffs's state law claims for common law fraud, breach of fiduciary duty, and violation of the North Carolina Securities Act, N.C. Gen. Stat. § 78A-56(a)(2) (1991). *Id.* at 586-89. In its May 22 Order the district court granted DH&S's motion for summary judgment as to Plaintiffs's claims under § 10(b) of the Securities and Exchange Act. *Venturtech II, Ltd. v. Deloitte, Haskins & Sells,* No. 88-1012-CIV-5-H (E.D.N.C. May 22, 1992) (unpublished).

We have reviewed the issues, studied the briefs and the record, and heard oral argument. We agree with the analysis of the district court and affirm on the basis of its reasoning.

AFFIRMED

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NORTH CAROLINA
RALEIGH DIVISION

NO. 88-1012-CIV-5-H

VENTURTECH II, LIMITED PARTNERSHIP; NORTH RIVERSIDE VENTURE, INC.; and HERITAGE CAPITAL CORPORATION,

Plaintiffs

v.

DELOITTE HASKINS & SELLS,

Defendant

v.

LEARNING RESOURCES, INC.; KITTY HAWK CAPITAL, INC.; CHRISTOPHER W. HEGELE; ROBERT L. CHAPMAN; and THOMAS BARRY,

Third Party Defendants and Additional Third Party Plaintiffs,

v.

GREYLOCK PARTNERS & CO.; ADVANCED TECHNOLOGY DEVELOPMENT FUND; DAVID L. STROHM and RONALD W. WHITE,

Additional Third Party Defendants.

FILED

MAY 22 1992

J. RICH LEONARD, CLERK
U.S. DISTRICT COURT
E. DIST. NO. CAR.

JUDGMENT

IT IS ORDERED AND ADJUDGED that by order of October 7, 1991, the court grants defendant Deloitte Haskins & Sells' motion for summary judgment on all plaintiffs' claims arising under Sec. 12(2) of the 1933 Act and Sec. 10(b) of the 1934 Act (Counts I and II).

By order of April 1, 1992, the court grants Deloitte Haskins & Sells' motion for summary judgment on all plaintiffs' claims based on N.C. Gen. Stat. Sec. 78A-56 (Count III), common law fraud (Count IV), breach of contract (Count V), professional negligence (Count VI), and breach of fiduciary duty (Count VII).

By order of April 1, 1992, the motions for summary judgment brought by Greylock Partners & Co., Advanced Technology Development Fund, David L. Strohm and Ronald W. White; Kitty Hawk Capital, Inc. and Christopher W. Hegele; North Riverside Heritage and Venture, Inc., Heritage Capital Corporation and Thomas Barry; and Robert L. Chapman for contribution are without basis and are dismissed.

By order of May 15, 1992, the court grants the defendant Deloitte Haskins & Sells' motion for summary judgment on plaintiffs' claims based on Sec. 10(b) and Rule 10b-5.

All claims in this action having been fully adjudicated, this action is HEREBY DISMISSED.

Dated: May 22, 1992 J. RICH LEONARD, Clerk

By: /s/ Ann Caviness
Deputy Clerk

THIS JUDGMENT WAS FILED AND ENTERED THIS 22nd DAY OF MAY, 1992.

[Service List Omitted in Printing]

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NORTH CAROLINA
RALEIGH DIVISION

NO. 88-1012-CIV-5-H

VENTURTECH II, LIMITED PARTNERSHIP; NORTH RIVERSIDE VENTURE, INC.; and HERITAGE CAPITAL CORPORATION,

Plaintiffs

v.

DELOITTE HASKINS & SELLS,

Defendant

v.

LEARNING RESOURCES, INC.; KITTY HAWK CAPITAL, INC.; CHRISTOPHER W. HEGELE; ROBERT L. CHAPMAN; and THOMAS BARRY,

Third Party Defendants and Additional Third Party Plaintiffs,

v.

GREYLOCK PARTNERS & CO.; ADVANCED TECHNOLOGY DEVELOPMENT FUND; DAVID L. STROHM and RONALD W. WHITE,

Additional Third Party Defendants.

FILED

MAY 15 1992

J. RICH LEONARD, CLERK
U.S. DISTRICT COURT
E. DIST. NO. CAR.

ORDER

This matter is before the court on the defendant's motion for summary judgment on plaintiffs' claims brought under § 10(b) of the Securities Exchange Act of 1934 ("the 1934 Act"), 15 U.S.C. § 78j(b), and the Securities Exchange Commission's corresponding Rule 10b-5. Alternatively, defendant moves the court to reinstate its contribution claims asserted under § 10(b) and Rule 10b-5 against the third-party defendants. The motion of third-party defendants Kitty Hawk Capital, Inc., and W. Christ Hegele to reinstate their contribution claims based upon § 10(b) and Rule 10b-5 against the additional third-party defendants is also ripe for ruling.

Plaintiffs' claims under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 771(2), were dismissed as time barred on October 7, 1991. Plaintiffs' § 10(b) and Rule 10b-5 claims, which also had been dismissed, were reinstated on February 4, 1992. By order filed April 2, 1992, (the "Order of April 2"), this court granted summary judgment in defendant's favor on plaintiffs' state law claims for violations of the North Carolina securities laws, common law fraud, breach of contract, professional negligence, and breach of fiduciary duty. Consequently, the federal securities claims and contribution claims asserted under § 10(b) and Rule 10b-5 now before the court are the only matters left to be decided in this action.

A detailed recitation of the facts of this case appears in the Order of April 2 and will not be repeated here. The cause of action consists primarily of plaintiffs' allegations that defendant Deloitte Haskins & Sells ("DH&S") violated § 10(b) of the 1934 Act and Rule 10b-5, or, in the alternative, aided and abetted Learning Resources, Inc., ("LRI"), in a primary violation, by issuing untrue and misleading statements and unqualified opinions regarding the financial statements of LRI upon which the plaintiffs, a group of venture capital investors, relied.

Summary judgment is appropriate when, in light of all the pleadings, depositions, affidavits, and answers to interrogatories, there is no genuine issue of material fact and the nonmoving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). If a party fails to establish a sufficient basis for an essential element of the case on which it bears the burden of proof, then summary judgment should be granted. *Celotex Corp. v. Catrett,* 477 U.S. 317, 322 (1986).

The plaintiffs allege that DH&S failed to perform its audit of LRI in accordance with Generally Accepted Auditing Standards ("GAAS") and, therefore, failed to uncover and disclose material information about LRI's financial condition. To support this allegation, plaintiffs present evidence intended to show that DH&S failed to acquire management representation letters from LRI's management, that DH&S used an improper method for the recognition of income, and that DH&S erred in not testing one of LRI's largest receivables, a contract with the University of North Carolina. Furthermore, plaintiffs assert that DH&S knew, or should have known, that potential investors would be relying on the 1982 through 1986 financial statements of LRI and DH&S' professional auditor's opinion as to the accuracy of those statements when making their investment decisions.

A Primary Violation

Section 10(b) of the 1934 Act proscribes the use of "any manipulative or deceptive device or contrivance in contravention of such rules or regulations as the Commission may prescribe" in connection with the purchase or sale of any security. 15 U.S.C. § 78j(b). Rule 10b-5, promulgated by the Commission pursuant to § 10(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails

> or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 CFR § 240.10b-5.

A cause of action for a primary violation of § 10(b) and Rule 10b-5 consists of four elements: 1) the making by the defendant of an untrue statement of material fact or the omission of a material fact that made the statements misleading; 2) in connection with the purchase or sale of a security; 3) with scienter; 4) causing plaintiff's loss. *Schatz v. Rosenberg,* 943 F.2d 485, 489 (4th Cir. 1991), *cert. denied sub nom, Schatz v. Weinberg & Green,* 112 S. Ct. 1475 (1992). The most problematic of these elements is the requirement of scienter. The exact mental state required for a § 10(b) and Rule 10b-5 violation continues to be a matter of great debate. The plaintiffs contend that recklessness is sufficient to satisfy the element of scienter. In contrast, DH&S argues that, absent a fiduciary duty to the plaintiff, the element of scienter requires that a defendant possess a high conscious awareness and intent to violate the securities laws.

In 1976, the Supreme Court held that a cause of action under § 10(b) and Rule 10b-5 could not be maintained without an allegation of scienter, that is, an intent to deceive, manipulate, or defraud. *See Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). The Court expressly rejected negligent conduct as a basis for a § 10(b) and Rule 10b-5 violation. *Id.* at 214. However, a footnote in *Hochfelder* became the spark that ignited the current debate over whether reckless conduct satisfies the requirement of scienter. In limiting the scope of its opinion, the Court stated:

> the term 'scienter' refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, *in certain circumstances,* reckless behavior is sufficient for civil liability under § 10(b) and Ruled 10b-5.

Id. at 193 n.12 (emphasis added).

Since *Hochfelder,* courts have grappled with the task of defining those "certain circumstances" in which recklessness is sufficient to satisfy the element of scienter. The Second Circuit has held that an appropriate circumstance for imposition of § 10(b) liability based upon recklessness exists where "reckless disregard for the truth was 'a form of intentional conduct.' " *In re Fischbach Corp. Secur. Litig.,* 1992 U.S. Dist. LEXIS 373, p*13, 14 (S.D.N.Y. Jan. 15, 1992), quoting *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38 (2d Cir.), *cert. denied,* 439 U.S. 1039 (1978). In analyzing the Second Circuit's interpretation of recklessness in § 10(b) cases, the district court in *Fischbach* stated that "reckless disregard of the truth is a form of intentional conduct if the defendants deliberately refrained from taking steps to discover whether their statements

were false or misleading, but that it is not a form of intentional conduct if the defendants' failure to investigate was not deliberate." *Id.* at p*14. The district court finally concluded that the appropriate circumstances in which recklessness is permitted to satisfy the scienter requirement are ones "where the circumstances suggest an egregious failure to gather information, which in turn suggests the defendant deliberately shut his eyes to the truth." *Id.* at p*19.

Other courts have imposed liability under § 10(b) and Rule 10b-5 upon a showing of recklessness if the defendant owed an independent duty of disclosure to the plaintiff. The Eighth Circuit held that "[r]ecklessness satisfies the knowledge requirement where the defendant owes a duty of disclosure to the plaintiff." *Camp v. Dema,* 948 F.2d 455, 459 (8th Cir. 1991) (discussing the element of scienter required for aiding and abetting a § 10(b) violation, which is the same as that required for a primary violation). Contrary to the plaintiffs' unqualified assertion that the scienter requirement can be satisfied by a showing of recklessness whenever a primary violation is alleged, the court believes that the greater weight of authority mandates that recklessness is a sufficient mental state only in those circumstances where an accountant owes an independent duty of disclosure to the plaintiffs. *See Akin v. Q-L Investments, Inc.,* 1992 U.S. App. LEXIS 6958 (5th Cir. April 15, 1992); *Camp v. Dema,* 948 F.2d 455, 462 (8th Cir. 1991).

The Fourth Circuit refused to hold that a law firm could be liable for misrepresentation under § 10(b) if it disseminated false information "with an intent, knowledge or awareness that the information will be communicated or disseminated to persons . . . in connection with the purchase or sale of a security." *Schatz v. Rosenberg,* 943 F.2d 485, 490 (4th Cir. 1991), quoting *Rose v. Arkansas Valley Envtl. & Util. Auth.,* 562 F. Supp. 1180, 1206 (W.D. Mo. 1983). Instead, the Fourth Circuit held "that a lawyer or

law firm cannot be held liable for misrepresentations under section 10(b) for failing to disclose information about a client to a third party absent some fiduciary or other confidential relationship with the third party." *Id.*

Although the plaintiffs contend that the holding in *Schatz* does not control the disposition of this case because of factual distinctions, the court finds that the analysis in *Schatz* is instructive on the issue of whether DH&S owed a duty of disclosure to the plaintiffs. The existence of a duty to disclose controls whether the plaintiffs must establish scienter of the reckless variety or of the actual knowledge and intent variety. In determining whether an attorney owed a duty of disclosure to third parties, the Fourth Circuit looked first to the federal securities laws, then to state law, and finally to general public policy. This framework serves as an appropriate guide for the court to follow to determine the question now presented; that is, whether DH&S, as a public accounting firm, owed a duty of disclosure to third-party investors.

In the Order of April 2, this court addressed the duties of an accountant to third-parties under North Carolina law and found that DH&S owed neither a general tort law duty of care nor a fiduciary duty to the plaintiffs. *See* Order of April 2 at 14-21, 24-25. The court based its finding on the lack of any evidence in the record that DH&S knew at the time it prepared its audit reports that LRI was soliciting new investors and that those investors would be relying on DH&S' audit reports and opinions. In accordance with these earlier findings, the court holds that the plaintiffs failed to present any evidence to support their claim that DH&S owed them a duty of disclosure under North Carolina law.

As the Fourth Circuit found in *Schatz,* a duty of disclosure arises under the federal securities laws from "a fiduciary or other similar relation of trust and confidence" between the parties. *Schatz,* 943 F.2d at 490 (quoting *Chi-*

arella v. United States, 445 U.S. 222, 228 (1980)). The existence of this special relationship creating a duty of disclosure may be established by state or federal law or by an analysis of five factors set out in *Roberts v. Peat, Marwick, Mitchell & Co.,* 857 F.2d 646 (9th Cir. 1988), *cert. denied,* 493 U.S. 1002 (1989). *Camp v. Dema,* 948 F.2d 455, 460 (8th Cir. 1991). The factors to be considered under the *Roberts* test are:

> 1. the relationship of the defendant to the plaintiff;
>
> 2. the defendant's access to information relative to the plaintiff's;
>
> 3. the benefits derived by the defendant in the relationship with the plaintiff;
>
> 4. the defendant's awareness of plaintiff's reliance; and
>
> 5. the defendant's activity in initiating the transaction in question.

Id. (quoting *Roberts,* 857 F.2d at 653-54).

This court previously found that no fiduciary relationship under state law existed between DH&S and the plaintiffs. *See* Order of April 2 at 24-25. Similarly, this court has found no federal law creating a general fiduciary or other special relationship between an accounting firm and public investors at large. In reviewing the five factors set forth in *Roberts,* this court is also unable to conclude that a fiduciary relationship existed between DH&S and the plaintiffs. The evidence fails to show that DH&S had any dealings or interaction with the plaintiffs, or that DH&S received any benefit, other than the receipt of payment for its services, from the plaintiffs' investment, or that DH&S in any way encouraged or solicited the plaintiffs. Although the plaintiffs presented evidence which they believe shows that DH&S knew, or should have known, of

plaintiffs' reliance on its audit reports, this evidence fails to show that DH&S was aware at the time it prepared the audit reports that new investors were being solicited. Therefore, this court finds that no fiduciary or special relationship existed between DH&S and the plaintiffs. Absent such a relationship, plaintiffs cannot rely on the recklessness standard but must establish that DH&S intended to violate § 10(b) and Rule 10b-5. Nor is there any evidence from which a juror could conclude that DH&S deliberately shut its eyes to the truth and intentionally failed to conduct a proper audit.

As this court concluded after analyzing plaintiffs' claims based upon N.C. Gen. Stat. § 78A-56(a)(2), the plaintiffs have not come forward with any evidence that DH&S entertained an intent to deceive, manipulate, or defraud. *See* Order of April 2 at 28. Because this degree of scienter is a necessary element of plaintiffs' § 10(b) and Rule 10b-5 claims on which it bears the burden of proof, and they have failed to establish a sufficient basis for this element, summary judgment can be granted on this basis alone. Therefore, the court finds that DH&S is entitled to summary judgment on plaintiffs' claims that it engaged in a primary violation of § 10(b) and Rule 10b-5.

Secondary Liability

A cause of action for aiding and abetting a securities violation requires the proof of three elements: 1) a primary violation by another; 2) the aider and abettor's knowledge of the primary violation; and 3) substantial assistance by the aider and abettor in achieving the primary violation. *Schatz,* 943 F.2d at 495. The second element—the aider and abettor's knowledge of the primary violation—is akin to the element of scienter in a primary violation. The mental state necessary to impose liability as an aider and abettor is the same as that required for a primary violation. *Ackerman v. Schwartz,* 947 F.2d 841 (7th Cir. 1991).

Without deciding whether DH&S engaged in substantial assistance of a primary violation, this court finds that DH&S is not liable as an aider and abettor because it lacked the requisite mental state. As this court found *infra*, the plaintiffs have not presented any evidence showing that DH&S intended to violate, or to assist in a violation of, § 10(b) and Rule 10b-5. Because scienter is a crucial element of an action for aiding and abetting a securities violation, this evidentiary deficiency entitles DH&S to judgment as a matter of law.

CONCLUSION

The plaintiffs have not presented any evidence to establish that DH&S possessed the necessary intent to commit a securities violation, or to aid and abet a securities violation. For that reason, the court finds that summary judgment in favor of DH&S is appropriate. Although the motion of third-party defendants Kitty Hawk Capital, Inc., and Christopher Hegele to reinstate their contribution claims against the additional third-party defendants is ripe for ruling, the court finds it unnecessary to rule on that motion in light of its finding that DH&S has not committed a securities violation. Likewise, DH&S' alternative motion to reinstate its contribution need not be addressed.

Accordingly, the court GRANTS the defendant DH&S' motion for summary judgment on plaintiffs' claims based on § 10(b) and Rule 10b-5. Having fully adjudicated all claims in this action, the court hereby DISMISSES this action.

This the 15th day of May, 1992.

/s/ Malcolm J. Howard
MALCOLM J. HOWARD
United States District Judge

At Greenville, NC
#19

APPENDIX D

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NORTH CAROLINA
RALEIGH DIVISION

NO. 88-1012-CIV-5-H

VENTURTECH II, LIMITED PARTNERSHIP; NORTH RIVERSIDE VENTURE, INC.; and HERITAGE CAPITAL CORPORATION,

Plaintiffs

v.

DELOITTE HASKINS & SELLS,

Defendant

v.

LEARNING RESOURCES, INC.; KITTY HAWK CAPITAL, INC.; CHRISTOPHER W. HEGELE; ROBERT L. CHAPMAN; and THOMAS BARRY,

Third Party Defendants and Additional Third Party Plaintiffs,

v.

GREYLOCK PARTNERS & CO.; ADVANCED TECHNOLOGY DEVELOPMENT FUND; DAVID L. STROHM and RONALD W. WHITE,

Additional Third Party Defendants.

FILED

APRIL 1, 1992

J. RICH LEONARD, CLERK
U.S. DISTRICT COURT
E. DIST. NO. CAR.

ORDER

This matter is before the court on numerous motions for summary judgment. Plaintiffs moved for partial summary judgment against defendant Deloitte Haskins & Sells ("DH&S") on their professional negligence and third-party contract claims related to the 1985 and 1986 financial statements. DH&S moved for summary judgment on plaintiffs' common law fraud, breach of contract, professional negligence, breach of fiduciary duty, and state securities law claims. Additional third-party defendants Greylock Partners & Co. ("Greylock"), Advanced Technology Development Fund ("ATDF"), David L. Strohm ("Strohm"), and Ronald W. White ("White") (collectively "Greylock, et al.") moved for summary judgment on the contribution claims based on negligence and state securities laws brought by additional third-party plaintiffs Kitty Hawk Capital, Inc. ("Kitty Hawk") and W. Christ Hegele ("Hegele").[1] Kitty Hawk and Hegele moved for summary judgment on the contribution claims based on negligence and state securities laws brought by DH&S. Plaintiffs North Riverside Venture, Inc., ("North Riverside"), Heritage Capital Corporation ("Heritage"), and third-party defendant Thomas Barry ("Barry") moved for summary judgment on the contribution claims based on negligence and state securities laws brought against them by DH&S, Kitty Hawk, and Hegele. Finally, third-party defendant Robert L. Chapman ("Chapman") requested summary adjudication of DH&S' claims against him for contribution based on negligence and state securities laws.

STATEMENT OF THE CASE

The plaintiffs, three venture capital investment firms, initiated this action on December 31, 1988, against DH&S,

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[1] The third-party defendant identified in the caption of DH&S' third-party complaint as Christopher W. Hegele is correctly identified as W. Christ Hegele.

an international public accounting firm, alleging violations of the federal and state securities laws, common law fraud, breach of contract, professional negligence/negligent misrepresentation, and breach of fiduciary duty in connection with DH&S' examination of annual financial statements issued by Learning Resources, Inc. ("LRI"). In its answer, DH&S generally denied the material allegations of the complaint. DH&S later filed an amended answer asserting a counterclaim against North Riverside and filed a third-party complaint against LRI; Robert L. Chapman ("Chapman"), the president, a director, and member of the executive committee of LRI; Barry, a director and member of the executive committee of LRI; Kitty Hawk, a venture capital investment firm which invested in LRI in 1984; and Hegele, a principal of Kitty Hawk and a director and member of the executive committee of LRI. DH&S contended that it was entitled to contribution and indemnification from LRI, Chapman, Kitty Hawk, Hegele, and Barry,[2] because they each had participated in the solicitation of plaintiffs' investments.

Kitty Hawk and Hegele asserted claims for contribution and indemnification against North Riverside, Barry, and Heritage and filed a third-party complaint against Greylock, et al., two venture capital investment firms and their principals, who served on LRI's audit committee and on its Board of Directors ("the Board"). This court dismissed all claims for contribution and indemnification, except claims based on negligence and state securities laws, by order of January 3, 1991.

In August 1991, upon DH&S' motion for summary judgment pursuant to the rule announced in *Lampf, Pleva, Lipkind, Prupis & Petrigrow v. Gilbertson,* 111 S. Ct. 2773 (1991), this court dismissed as time barred plaintiffs' federal securities claims. On February 24, 1992, the court

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[2] DH&S' claim against Barry is limited to liability arising from plaintiff Venturtech II's ("Venturtech") investment.

reinstated the plaintiffs' claims brought under § 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), and Rule 10b-5 promulgated thereunder, as required by § 27A of the 1934 Act, enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242. Meanwhile, Greylock, et al., Kitty Hawk and Hegele, and North Riverside, Heritage, and Barry moved for summary judgment on the remaining contribution and indemnification claims against them. Plaintiffs moved for partial summary judgment on their breach of contract and professional negligence/negligent misrepresentation claims related to the 1985 and 1986 financial statements. Defendant DH&S moved for summary judgment on all state law claims against it. After exhaustive and voluminous briefing by all parties on the pertinent issues, this matter is ripe for adjudication.

STATEMENT OF THE FACTS

Chapman purchased LRI[3] in the mid 1970s. LRI engaged in the business of "visual publishing." A Delaware corporation operating out of Durham, North Carolina, LRI prepared and marketed audiovisual presentations describing colleges and universities for use in high schools. LRI also developed and marketed interactive audiovisual materials for corporate training and education.

Needing additional financial support, Chapman raised over one million dollars in venture capital from three venture capital investors—Greylock, ATDF, and Kitty Hawk—between 1981 and the end of 1986. Greylock, the initial venture capital investor, invested $400,000 in LRI in November 1982. Greylock received two seats on the Board in exchange for its investment, one of which was held by Strohm, its principal. On October 2, 1984, ATDF invested

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[3] LRI was formerly known as Controlled Distribution Networks, Inc. The company changed its name several times since its inception and will be referred to in this order only as LRI.

$300,000 in LRI and received a seat on the Board, which was held by White, its principal. Kitty Hawk invested $100,000 in LRI in December 1984, but did not receive a seat on the Board for its principal, Hegele, until June 1986. At the May 17, 1985, Board meeting, the Board approved the formation of an audit committee comprised of Strohm and White.

The three original venture capital investors made further investments in LRI as its need for capital continued. In September 1986, as LRI was attempting to expand its corporate division, LRI's officers solicited approximately six venture capital firms regarding an investment in LRI. As a result, two new venture capital firms invested in LRI on December 31, 1986: plaintiff North Riverside, investing approximately $350,000, and plaintiff Heritage, investing approximately $250,000. In the spring of 1987, LRI still needed approximately $750,000 in additional capital. After Duff Meyercord, a principal of Venturtech, attended a meeting of the LRI Executive Committee held on May 22, 1987, Venturtech invested approximately $500,000 on June 11, 1987, and Meyercord became a member of the Board and the Executive Committee.

In January 1988, the Board fired Chapman and dissolved the corporate division. In an effort to revive the educational division, LRI's officers drafted a new business plan which projected a need for additional capital in the amount of $750,000. The existing investors provided this additional capital in pro rata shares. By April 1988, LRI was again in need of further capital. At this point, the venture capital investors—Greylock, ATDF, Kitty Hawk, North Riverside, Heritage, Venturtech, and Hickory Venture Capital Corporation[4]—refused to invest any further capital and LRI's remaining assets were eventually sold.

The facts pertaining to DH&S' initial involvement with LRI are somewhat sketchy. In a letter dated July 31, 1981,

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[4] Hickory Venture Capital Corporation is not a party to this law suit.

DH&S agreed to audit LRI's financial statements and issue a report thereon for the fiscal years ending on September 30, 1980, and September 30, 1981. Pls.' Ex. 25. However, the earliest document in the record prepared by DH&S is the Consolidated Financial Statement for the Year Ended December 31, 1981 and Auditor's Report. Pls.' Ex. 1. DH&S describes this document as a nine-month financial review, and not a full audit. DH&S audited and reported on LRI's financial statements for the years 1982, 1983, 1984, 1985, and 1986. DH&S represented that each examination was made in accordance with Generally Accepted Auditing Standards ("GAAS") and reflected the consistent application of Generally Accepted Auditing Principles ("GAAP").

Plaintiffs' allegations are centered around the contention that LRI's financial statements for the years 1982 through 1986 contain material misrepresentations and inaccuracies. Specifically, the plaintiffs contest the recognition of income, particularly the recognition of income in 1986 from a contract with the University of North Carolina (the "UNC contract") that had not been signed, and allege that DH&S failed to obtain management representation letters for 1985 and 1986 as required by GAAS. The notes to LRI's audited financial statements set forth the method of income recognition used by DH&S.

DISCUSSION

I. The Standard for Summary Judgment

Summary judgment is appropriate if, after reviewing all pleadings, depositions, answers to interrogatories, admissions, and affidavits, there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). The court should grant a motion for summary judgment when the record as a whole could not lead a rational juror to find for the nonmoving party. *Matsushita Elec. Indus. Co. v. Zenith*

Radio Corp., 475 U.S. 574, 587 (1986). As a vital part of federal civil procedure, summary judgment facilitates the "just, speedy and inexpensive determination of every action." *Celotex Corp. v. Catrett*, 477 U.S. 317, 327 (1986).

II. Plaintiffs' Breach of Contract Claims

Plaintiffs and DH&S have filed cross-motions for summary judgment on plaintiffs' breach of contract claims. The plaintiffs allege that they are intended third-party beneficiaries of the contract to provide auditing services between DH&S and LRI.

A. Requirements for a Third-Party Beneficiary Contract[5]

North Carolina contract law determines the rights of third-party beneficiaries according to the Restatement (Second) of Contracts. *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 329 N.C. 646, 651, 407 S.E.2d 178, 181 (1991).[6] Section 302 of the Restatement (Second) of Contracts provides:

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[5] The plaintiffs assert that the analysis of the court of appeals' decision in *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 79 N.C. App. 81, 339 S.E.2d 62 (1986), remains intact and is the applicable standard. The court disagrees. The North Carolina Supreme Court's discussion of the rights of third-party beneficiaries in *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 329 N.C. 646, 407 S.E.2d 178 (1991), is complete and without reservation and makes no acknowledgement of the court of appeals' analysis. As the controlling authority in the State of North Carolina, the Supreme Court's analysis of the rights of third-party beneficiaries must take precedence over the court of appeals' analysis.

[6] The underlying facts of *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 322 N.C. 200, 367 S.E.2d 609 (1988) ("*Raritan I*") and *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 329 N.C. 646, 407 S.E.2d 178 (1991) ("*Raritan II*") are the same. In *Raritan I*, the court addressed the scope of an accountant's liability to third parties for negligent misrepresentation. In *Raritan II*, the court addressed whether a nonclient trade creditor could sue an accounting firm for breach of contract as a third-party beneficiary.

> (1) Unless otherwise agreed between promisor and promise, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either
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> (a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or
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> (b) the circumstances indicate that the promise intends to give the beneficiary the benefit of the promised performance.
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> (2) An incidental beneficiary is a beneficiary who is not an intended beneficiary.

Restatement (Second) of Contracts § 302 (1981).

In applying this analysis, the North Carolina Supreme Court concluded that the parties' "intent to benefit" is the determining factor in whether a third-party beneficiary is entitled to recover on the contract. *Raritan II,* 329 N.C. at 652, 407 S.E.2d at 182. The parties' intent is discerned from the "circumstances surrounding the transaction as well as the actual language of the contract," which must be " 'construed strictly against the party seeking enforcement.' " *Id.* (quoting *Chemical Realty Corp. v. Home Fed. Savings & Loan,* 84 N.C. App. 27, 34 (1987)).

In *Raritan II,* trade creditors of a corporation sued the accounting firm that prepared the corporation's audit as third-party beneficiaries of the corporation's contract with the accounting firm. The court concluded that the corporation and the accounting firm did not intend to benefit the trade creditors and remanded the case for reinstatement of the order for summary judgment for the accounting firm. *Id.* at 654, 407 S.E.2d at 183. The Supreme Court identified several specific factors relevant to the inquiry into the parties' intent. The court considered 1)

the parties' lack of knowledge that the audited financial statements would be provided to a third party; 2) the failure to designate in the contract a third party as an intended beneficiary; and 3) whether audited financial statements were delivered directly to the third party. *Id.* at 653-54, 407 S.E.2d at 183. However, the court emphasized that the entire record, not any single factor, was dispositive as to the parties' intention. *Id.* at 654, 407 S.E.2d at 183.

B. Circumstances Surrounding the LRI-DH&S Contract

Before this court can conclude that plaintiffs are intended third-party beneficiaries of the LRI-DH&S audit engagement, this court must find that LRI and DH&S intended to benefit the plaintiffs by their contract *and* that LRI intended to give the plaintiffs the benefit of DH&S' audit. *See Raritan II,* 329 N.C. at 651, 407 S.E.2d at 181. Noticeably absent from the record in this case is a written contract between LRI and DH&S.[7] Thus, the court's determination must be made solely from the circumstances surrounding DH&S' provision of accounting services.

The plaintiffs direct the court's attention to numerous facts in the record which allegedly indicate that LRI and DH&S intended the plaintiffs to benefit from their auditing engagement. First, plaintiffs suggest that DH&S knew that LRI intended to raise capital to finance its operations. Plaintiffs also argue that their status as intended beneficiaries can be inferred from the general purpose of a professional audit—"to enhance the credibility of LRI's financial statements in the eyes of prospective investors."

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[7] The basic terms of the audit engagement were set forth in two memoranda: a confirmation letter dated July 31, 1981, from DH&S to LRI and signed by Chapman and Samuel W. McNairy, a partner at DH&S, Pls.' Ex. 25; and, a similar letter dated December 14, 1983, signed by McNairy but not countersigned by an agent of LRI. Pls.' Ex. 26.

Pls.' Memorandum in Support of Motion for Summary Judgment at 45 (hereinafter Pls.' Mem.). Similarly, plaintiffs assert that, because DH&S was aware of the general practice that prospective investors require audited financial statements before investing in a company, the parties intended to benefit the plaintiffs by their contract. In support of this assertion, the plaintiffs contend that, because the audits were conducted in accordance with national accounting standards, LRI and DH&S must have intended to benefit potential third-party investors.

Focusing on more specific factors, plaintiffs argue that "LRI intended to give prospective investors, including plaintiffs, the benefit of [DH&S'] promised performance, and [DH&H] knew of LRI's intent." Pls.' Mem. at 46. As evidence of DH&S' knowledge of LRI's intent, plaintiffs cite 1) an auditor's internal memorandum from 1982 recognizing that LRI was using DH&S's work in connection with negotiations with Greylock; 2) an auditor's notation in a pre-audit planning document dated December 2, 1986, stating that LRI intended to raise capital by issuing preferred stock; 3) a similar auditor's notation indicating that LRI intended to raise additional capital from new investors; and 4) minutes of a November 13, 1986, meeting of LRI's board of directors obtained by DH&S in the course of the 1986 audit revealing that sic venture capital firms were considering investing in LRI.

After examining carefully the arguments presented on behalf of the parties and the discovery materials cited therein, this court finds that the evidence fails to support a conclusion that the plaintiffs were intended third-party beneficiaries. No direct evidence supports the plaintiffs' contention that LRI and DH&S intended to benefit them by their audit contract. Likewise, the circumstances surrounding DH&S' auditing engagement do not reveal any such intent. Plaintiffs' reference to such general factors as the primary purpose of an audit, the usual reliance of investors on audited financial statements, DH&S' status

as an international accounting firm, and the application of national standards is too generic to support a finding that LRI and DH&S intended these plaintiffs to benefit from their contract. A finding to the contrary would make every venture capital investor an intended beneficiary of every auditing engagement between an accounting firm and its client. It is to prevent such expansive liability from attaching solely on the basis of generalities that strict construction against the party seeking enforcement is required. *See Raritan II,* 329 N.C. at 652, 407 S.E.2d at 182.

Similarly, the court is not persuaded by the plaintiffs' evidence related to more specific factors. The 1982 auditor's memorandum identifying Greylock as a potential investor who would be relying on DH&S' audit report during negotiations, Pls.' Ex. 14, is not sufficient evidence by itself to prove that the parties or LRI alone intended to make *any* potential venture capital investor at *any* future time a third-party beneficiary of the audit engagement. The numerous documents allegedly indicating that DH&S knew that LRI was soliciting new investors. Pls.' Exs. 15, 16, 17, also fail to establish the existence of a third-party beneficiary relationship. These documents are all dated *after* the completion of the 1985 audit, making them irrelevant as to the 1982-1985 audits. The overall import of these documents is that new investors would invest by December 30, 1986, thereby precluding any possible benefit from relying on the 1986 audit, which was not performed until early 1987.

When construed strictly against the plaintiffs, the circumstances surrounding the audit engagement fail to show that the parties intended to bestow any benefit from that engagement on the plaintiffs. The plaintiffs were never designated as third-party beneficiaries in any contract between LRI and DH&S. The annual audit and financial statements were never distributed by DH&S to the plaintiffs. With the exception of the 1982 financial report, which was prepared with knowledge that Greylock would

be relying on it, the record contains no evidence that DH&S knew that the financial statements prepared by it were distributed to, or used by, venture capital investors. More importantly, the record contains no evidence that DH&S knew that it was preparing the 1985 and 1986 financial statements for the plaintiffs' use in making an investment decision.

Therefore, the court finds that the plaintiffs were not intended third-party beneficiaries of DH&S' auditing engagement with LRI and may not recover on the contract. Plaintiffs' motion for summary judgment on their breach of contract claim is denied and DH&S' motion for summary judgment, in relation to the 1985 and 1986 financial statements, is granted.

III. Negligent Misrepresentation

The North Carolina Supreme Court defined the tort of negligent misrepresentation as a party's justifiable reliance "to his detriment on information prepared without reasonable care by one who owed the relying party a duty of care." *Raritan I,* 322 N.C. 200, 206, 367 S.E.2d 609, 612 (1988) (citing *Howell v. Fisher,* 49 N.C. App. 488, *disc. rev. denied,* 302 N.C. 218 (1981)). The court in *Raritan I,* determining the scope of an accountant's liability to third parties, adopted the Restatement (Second) of Torts approach. *Id.* at 214, 367 S.E.2d at 617.

The Restatement (Second) of Torts § 552 provides:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

> (2) . . . [T]he liability stated in Subsection (1) is limited to loss suffered
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> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
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> (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Restatement (Second) of Torts § 552 (1977).

The court in *Raritan I* expressed its understanding of § 552 as follows:

> [A]n accountant who audits or prepares financial information for a client owes a duty of care not only to the client but to any other person, or one of a group of persons, whom the accountant or his client intends the information to benefit; and that person reasonably relies on the information in a transaction, or one substantially similar to it, that the accountant or his client intends the information to influence. If the requisite intent is that of the client and not the accountant, then the accountant must know of his client's intent at the time the accountant audits or prepares the information.
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> . . .
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> . . . [The Restatement approach] recognizes that liability should extend not only to those with whom the accountant is in privity or near privity, but also to those persons, or classes of persons, whom he knows and intends will rely on his opinion, or whom he knows his client intends will so rely. On the other hand, . . . it prevents extension

> of liability in situations where the accountant "merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the audited financial statements], on the part of anyone to whom it may be repeated."

Raritan I, 322 N.C. at 210, 214, 367 S.E.2d at 614, 517 (quoting Restatement (Second) of Torts § 552, Comment h).

Applying this analysis, the plaintiffs assert that they are members of a class of persons whom DH&S knew would rely on LRI's financial statements. To support this assertion, they cite the same evidence used to support their third-party beneficiary claims. The court finds that this evidence is not sufficient to establish a duty owed to plaintiffs for either the 1985 or the 1986 financial statements.

A. Plaintiffs' Reliance on the 1985 Audit

Plaintiffs North Riverside and Heritage invested in LRI on December 31, 1986. Plaintiff Venturtech invested on June 11, 1987. These investments occurred *after* DH&S had completed the 1985 audit.[8] Furthermore, North Riverside and Heritage invested *before* work on the 1986 audit commenced.[9] All three plaintiffs received an initial solicitation from LRI in the fall of 1986. Therefore, North Riverside and Heritage's allegations of reliance relate chronologically only to the 1985 financial statement issued in 1986.

In order to establish that DH&S owed a duty to the plaintiffs in relation to the preparation of the 1985 finan-

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[8] Work on the 1985 audit was conducted in January, February, and March of 1986. The final audit was issued in April 1986.

[9] Work on the 1986 audit was conducted in Janaury, February, and March of 1987. The final audit was issued in April 1987.

cial statements, plaintiffs must prove either 1) that plaintiffs are members of a class of persons whom DH&S intended the audit to benefit, and that they reasonably relied on the audit, or 2) that plaintiffs are members of a class of persons whom LRI intended the audit to benefit, that DH&S knew of LRI's intent at the time it prepared the financial statements, and that they reasonably relied on the audit.

There is no evidence that DH&S intended its audit and preparation of financial statements to benefit anyone, or any class of persons, other than LRI. Therefore, the court concludes that DH&S did not harbor an intent to benefit the plaintiffs in the auditing and preparation of LRI financial statements.

Under the second item of proof above, the evidence submitted to the court fails to establish that DH&S knew at the time it audited and prepared the 1985 financial statements that LRI intended to use the 1985 financial statements in the solicitation and for the benefit of new venture capital investors.[10] The plaintiffs were not approached by LRI until September 1986. The only evidence offered by the plaintiffs to show that, prior to the preparation of the 1985 financial report, DH&S knew that LRI intended to use financial information audited by DH&S for the benefit of potential investors, is an auditor's memorandum dated November 18, 1982, stating "[c]lient is in (sic) process of negotiating a venture capital deal with Greylock of Boston, Mass. and our review report will be relied upon during their negotiations." Pls.' Ex. 14. Without any additional supporting evidence, the court finds that this memorandum alone is insufficient to lead a rational juror to conclude that, more than four years later, DH&S

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[10] Because the court finds that DH&S had no knowledge of LRI's alleged intent in early 1986, when it was preparing the 1985 financial report, the court expresses no opinion as to whether plaintiffs are members of a group of persons whom LRI intended to benefit.

knew that LRI would be soliciting new venture capital investors using the 1985 financial report. The 1982 memorandum, by itself, does not establish a "limited group of persons whom DH&S knew would rely on its work." Pls.' Mem. at 54. There is neither evidence that DH&S knew during 1983, 1984, and 1985 that LRI was soliciting a specified group of investors who were relying on DH&S' audits nor evidence that DH&S knew that LRI intended to solicit a certain class of potential investors. Therefore, the court finds that it is factually impossible for DH&S to have known in January, February, and March of 1986 that plaintiffs would be relying upon the audit and financial statement. The court believes that this conclusion represents accurately and fairly the North Carolina Supreme Court's interpretation of the Restatement (Second) of Torts § 552 in *Raritan I*.[11]

In light of *Raritan I*, DH&S' knowledge that a venture capital investor had invested in LRI in the past, and that venture capital investors generally rely on financial statements is insufficient to establish a duty to the plaintiffs. Therefore, plaintiffs North Riverside, Heritage, and Ven-

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[11] Comment h of § 552 provides the following example:

> A, an independent public accountant, is retained by B Company to conduct an annual audit of the customary scope for the corporation and to furnish his opinion on the corporation's financial statements. A is not informed of any intended use of the financial statements; but A knows that financial statements, accompanied by an auditor's opinion, are customarily used in a variety of financial transactions by the corporation and that they may be relied upon by lenders, investors . . . and the like . . . . In fact B Company uses the financial statements and accompanying auditor's opinion to obtain a loan from X Bank. Because of A's negligence, he issues an unqualifiedly favorable opinion upon a balance sheet that materially misstates the financial position of B Company and through reliance upon it X Bank suffers pecuniary loss. A is not liable to X Bank.

Restatement (Second) of Torts § 552, Comment h, Example 10.

turtech cannot state a claim for negligent misrepresentation arising from the 1985 financial statement against DH&S, and their motion for summary judgment must be denied.

B. Venturtech's Reliance on the 1986 Audit

Venturtech invested in June 1987, specifically awaiting the issuance of the 1986 financial statement before making an investment decision. Venturtech alleges specific facts in support of its contention that, by the fall of 1986, DH&S had knowledge of the plaintiffs' investments. Plaintiff Venturtech points to a Special Audit Risk Questionaire, Pls.' Ex. 16, prepared in December 1986 in preparation for the 1986 audit which acknowledged affirmatively that LRI had "plans to sell debt or equity securities or to obtain other financing in the near future." Pls.' Ex. 16 at 2. Attached to that exhibit is a narrative of special audit risks, apparently formulated from a series of questions directed to LRI, indicating that "the client anticipates issuing approximately $750,000 of Class B Preferred stock *prior to 12/31/86." Id.* at Bate stamp 104288 (emphasis added). Venturtech also cites the minutes of a November 13, 1986, LRI board meeting that were attached to DH&S' workpapers. The minutes state that "[s]ix venture firms were considering an investment in LRI. Heritage and North Riverside had submitted a term sheet." Pls.' Ex. 15 at 3. Finally, Venturtech refers to notes entitled "Discussion with Client Personnel," dated December 2, 1986, stating that "the client hopes to raise approximately $750,000 in capital by issuing Class B preferred stock prior to 12/31/86 to *new* investors. DH&S will analyze any stock transactions that occur at final." Pls.' Ex. 17 at 1.

This evidence undoubtedly shows that in late 1986 DH&S knew that LRI was soliciting a small group of new investors. However, to establish a duty in relation to the preparation of the 1986 financial statements, the evidence must support a finding that, *at the time DH&S was preparing*

the 1986 financial statements in early 1987, DH&S knew that LRI would use *the 1986 financial statements* to represent its financial condition to the anticipated investors, and that the anticipated investors would be relying on *the 1986 financial statements*. *See Raritan I*, 322 N.C. at 215, 367 S.E.2d at 617.

The court finds that the evidence fails to establish these essential elements. Viewed as a whole, Venturtech's evidence shows that the solicitation of six new investors and the raising of $750,000 additional capital were interrelated transactions which would occur *by December 31, 1986*. *See* Pls.' Ex. 16 at Bate Stamp 104288; Pls.' Ex. 17 at 1. The solicitation of new investors was occurring in the fall of 1986, with new investments expected prior to year-end, or "in the near future." Pls.' Ex. 16 at 2. Although DH&S knew that LRI was soliciting immediate new investments, DH&S also knew that its 1986 audit would not be completed, and an opinion issued, until later in 1986, long after the anticipated new investments were completed. The plaintiff offers no evidence that LRI informed DH&S that its financial statements would be relied on in connection with these new investments. Therefore, the court finds that the plaintiffs' evidence fails to establish that DH&S knew at the time it prepared the 1986 financial statement that Venturtech, as a member of a limited group of investors, would be relying on its report. Thus, DH&S did not owe a duty to Venturtech. Accordingly, Venturtech's motion for summary judgment based upon the 1986 financial statement must be denied. For the same reasons, DH&S' motion for summary judgment as to plaintiff's breach of contract claims arising from the 1985 and 1986 financial statements must be granted.

IV. DH&S's Motion for Summary Judgment

In addition to the claims for breach of contract and professional negligence discussed above and similar claims relating to the 1982 through 1984 financial statements,

DH&S moved for summary judgment on plaintiffs' state law claims for common law fraud, breach of fiduciary duty, and violation of § 78A-56 of the North Carolina Securities Act. The plaintiffs' claims are based upon alleged misrepresentations in the 1982, 1983, 1984, 1985, and 1986 financial statements of LRI and DH&S' failure to comply with GAAS and GAAP. Plaintiffs fault primarily the recognition of income in 1986 from an unsigned contract with the University of North Carolina ("the UNC contract") and DH&S' alleged failure to obtain management representation letters for 1985 and 1986.

A. Breach of Contract and Negligence Arising From the 1982 through 1984 Financial Statements

This court has already determined that DH&S is entitled to summary judgment on plaintiffs' breach of contract and professional negligence/negligent misrepresentation claims in connection with the 1985 and 1986 financial statements. For the same reasons stated above, this court finds that the plaintiffs were not third-party beneficiaries of the auditing engagements for 1982, 1983, or 1984. Similarly, the court finds that DH&S did not owe a duty to the plaintiffs when the 1982, 1983, and 1984 audits were performed. Therefore, DH&S is entitled to judgment as a matter of law on plaintiffs' breach of contract and professional negligence/negligent misrepresentation claims.

B. Common Law Fraud

The elements of an action for fraud in North Carolina are 1) a material misrepresentation of fact; 2) that is definite and specific; 3) made with knowledge of its falsity or in culpable ignorance of its truth; 4) made with the intent that it be acted upon; 5) reasonable reliance by the plaintiff on the misrepresentation; and 6) resulting damage to the injured party. *Forbes v. Ten Group, Inc.*, 99 N.C. App. 587, 594, 394 S.E.2d 643, 647 (1990), *review denied*, 328 N.C. 89, 402 S.E.2d 824 (1991). To be actionable, a fraudulent statement must be made with scienter. *Myers*

& Chapman, Inc. v. Thomas G. Evans, Inc., 323 N.C. 559, 568, 374 S.E.2d 385 (1988). Scienter requires both knowledge of a statement's falsity or reckless indifference to its truth, and an intent to deceive. *Id.* Defendant's motion for summary judgment on this claim is grounded in part upon its contention that it did not intend to deceive anyone; consequently, it lacked the necessary scienter. DH&S asserts that, even if it knew or should have known of the misrepresentations in the financial statements, it did not intend to deceive anyone.

In their response to DH&S' motion for summary judgment, plaintiffs contend for the first time that DH&S is liable for aiding and abetting the commission of a fraud. The plaintiffs have not cited, nor has this court located on its own, a North Carolina case recognizing a cause of action for aiding and abetting a fraud. Instead, the plaintiffs rely on North Carolina's recognition of aider and abettor liability for intentional torts, and on the Supreme Court's adoption of § 876(b) of the *Restatement of Torts,* pertaining to aider and abettor liability, in *Boykin v. Bennett,* 253 N.C. 725, 118 S.E.2d 12 (1961).

Without deciding whether aiding and abetting a fraud is a cognizable cause of action in North Carolina,[12] this court concludes that the plaintiffs failed to meet their burden of proof related to their fraud claim. There is no evidence that the defendant intended to deceive the plaintiff investors or anyone else. Furthermore, even if aiding and abetting a fraud is actionable, the plaintiffs still must prove that LRI committed a fraud, that DH&S knew of that fraud, and that DH&S provided substantial assistance in the accomplishment of that fraud. *Blow v. Shaughnessy,* 88 N.C. App. 484, 364 S.E.2d 444 (1988).

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[12] *But cf. Gilbert v. Bagley,* 492 F. Supp. 714, 735 (M.D.N.C. 1980) (finding aider and abettor liability under N.C. Gen. Stat. § 55-35 because of the North Carolina Supreme Court's approval of *Restatement of Torts* § 876 in *Boykin v. Bennett,* 253 N.C. 725, 118 S.E.2d 12 (1961)).

To prove that DH&S provided substantial assistance to LRI's alleged primary violation, the plaintiffs must show a "substantial causal connection between the culpable conduct of [DH&S] and the harm to the plaintiff[s], or a showing that the encouragement or assistance is a substantial factor in causing the resulting tort." *Id.* at 491 (quoting *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985) (citations omitted)). The fact that the plaintiffs relied heavily upon LRI's audited financial statements in making their investment decision cannot elevate DH&S' role of outside auditor to that of substantial participant in an alleged fraud. Without any evidence of an intent to deceive on the part of DH&S, this court cannot conclude that DH&S engaged in any culpable conduct subjecting it to liability as an aider and abettor. Therefore, DH&S' motion for summary judgment on plaintiffs' common law fraud claims must be granted.

C. Breach of Fiduciary Duty

A fiduciary duty may arise in one of two ways: either from a legal relationship, such as attorney and client, or from a special relationship in which confidence is reposed on one side and superiority or influence on the other. *Frizzell Constr. Co. v. First Citizens Bank & Trust Co.*, 759 F. Supp. 286, 290 (E.D.N.C. 1991). Although no legal relationship existed between plaintiffs and DH&S, plaintiffs allege that a fiduciary relationship existed between them and DH&S because they "reposed confidence in DH&S and its audit work, and were consequently influenced by it." Pls.' Response to Defendant [DH&S'] Motion for Summary Judgment at 14 (hereinafter Pls.' Response).

In order to give rise to a fiduciary duty, the special relationship must involve both a certain degree of trust or confidence and an element of superiority or influence. Although the court believes that the plaintiffs reposed a certain degree of confidence in DH&S as an internationally renowned accounting firm, and thereby accepted as true

the representations made in LRI's financial statements, this court does not find that DH&S exercised any superior control or influence over the plaintiffs sufficient to establish a fiduciary duty. There is no evidence before the court that DH&S, in preparing LRI's financial statements, acted in a way to influence or control the plaintiffs in their investment decision. Therefore, the court concludes that DH&S did not owe a fiduciary duty to plaintiffs and, accordingly, grants DH&S' motion for summary judgment as to plaintiffs' claims for breach of fiduciary duty.

D. North Carolina Securities Law

The plaintiffs allege in Count III of the complaint that DH&S is liable, either as a substantial participant or as an aider and abettor, for a violation of North Carolina General Statute § 78A-56 (1991). Section 78A-56(a)(2) imposes civil liability on any person who

> [o]ffers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission . . .

N.C. Gen. Stat. § 78A-56(a)(2) (1991).

Section 78A-56(a)(2) creates an express cause of action only against an offeror or seller. Whether an implied cause of action exists under this section against aiders and abettors or other substantial participants is hotly contested by the parties. The plaintiffs argue that, pursuant to this court's earlier interpretation of § 12(2) of the Securities Act of 1933 ("the 1933 Act") upholding aider and abettor liability, the court should follow the same reasoning here.

To the contrary, the defendant contends that aider and abettor liability is not appropriate under either § 12(2) of the 1933 Act or § 78A-56.

Because § 78A-56 parallels § 12(2) of the 1933 Act, cases construing § 12(2) should be considered when interpreting § 78A-56. *See State v. Williams,* 98 N.C. App. 274, 390 S.E.2d 746 (1990). Both the United States Supreme Court and the Court of Appeals for the Fourth Circuit have refrained expressly from deciding whether § 12(2) liability extends to non-statutory sellers as aiders and abettors. *See Pinter v. Dahl,* 486 U.S. 622, 642 n.20, 108 S. Ct. 2063, 2076 n.20 (1988); *Schatz v. Rosenberg,* 943 F.2d 485, 496 n.5 (4th Cir. 1991), *cert. denied, Schatz v. Weinberg & Green,* 1992 U.S. LEXIS 1731 (1992); *Baker, Watts & Co. v. Miles & Stockbridge,* 875 F.2d 1101 (4th Cir. 1989). As the plaintiffs point out, this court in past decisions has extended § 12(2) liability to aiders and abettors. *See, e.g., In re Conner Bonds Litig.,* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,969 at 90,525 (E.D.N.C. July 21, 1988). Without revisiting the question of aider and abettor liability under § 12(2), the court finds that, assuming aider and abettor liability under § 78A-56, the plaintiffs cannot support such a cause of action.

A cause of action for aiding and abetting a securities violation is comprised of three elements. The plaintiff must prove "(1) a primary violation by another person; (2) the aider and abettor's 'knowledge' of the primary violation; and (3) substantial assistance by the aider and abettor in the achievement or consummation of the primary violation." *Schatz,* 943 F.2d at 495. Addressing the second element, the Fourth Circuit held that, absent a duty owed to the plaintiff by the alleged aider and abettor, the defendant aider and abettor must possess "a 'high conscious intent' and a 'conscious and specific motivation' to aid the fraud." *Id.* at 496 (citing *ITT, an Int'l Invest. Trust v. Cornfeld,* 619 F.2d 909, 925 (2d Cir. 1980)). This court has already determined that the defendant did not owe a

duty to the plaintiffs. Therefore, the plaintiffs are required to prove that DH&S entertained a "high conscious intent" and "specific motivation" to aid the alleged securities violation committed by LRI.

The plaintiffs have neither alleged nor proven that DH&S possessed such a state of mind. The court cannot find in the record, and the plaintiffs have not presented any evidence indicating that DH&S conducted its audits with a "high conscious intent" to aid a securities violation. Absent such knowledge, the defendant cannot be liable as an aider and abettor.

Furthermore, this court concludes that the plaintiffs failed to establish that DH&S substantially assisted the primary violation. The plaintiffs assert that DH&S' assistance was substantial because the audited financial statements were the primary documents relied upon by the investors. However, in *Schatz,* the Fourth Circuit held that one who prepares documents containing material misrepresentations or omissions, in that case a lawyer, "must actively participate in soliciting sales or negotiating terms of the deal on behalf of a client to have 'substantially assisted' a securities violation." *Schatz,* 943 F.2d at 497.

There is no evidence that DH&S assisted LRI in its solicitation of investors. DH&S merely conducted an annual audit and issued annual financial statements containing its opinion as to LRI's financial condition. The fact that DH&S prepared allegedly misleading documents that were subsequently relied upon by the plaintiffs is not enough to establish that DH&S substantially assisted a securities violation. Accordingly, because the plaintiffs have failed to prove that DH&S possessed a "high conscious intent" to assist LRI in soliciting investors by untrue and misleading statements, and that DH&S substantially assisted such a violation, the plaintiffs cannot establish a claim for aiding and abetting a violation of § 78A-56. Sum-

mary judgment is, therefore, granted in favor of DH&S on plaintiffs' claims under N.C. Gen. Stat. § 78A-56.

CONCLUSION

Having concluded that there is no genuine issue as to any material fact relating to Venturtech, North Riverside, and Heritage's state law claims against DH&S, the court hereby GRANTS DH&S' motion for summary judgment on all plaintiffs' claims based on N.C. Gen. Stat. § 78A-56 (Count III), common law fraud (Count IV), breach of contract (Count V), professional negligence (Count VI), and breach of fiduciary duty (Count VII). Accordingly, plaintiffs' motion for partial summary judgment is DENIED.

Because DH&S is not liable to the plaintiffs on any of the above claims, the pending motions for summary judgment brought by Greylock, et al.; Kitty Hawk and Hegele; North Riverside, Heritage, and Barry; and Chapman for contribution are without basis and are hereby DISMISSED.

The only unresolved claims remaining in this action are plaintiffs' claims based upon § 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder which were reinstated on February 24, 1992. Filed on March 20, 1992, and currently pending in this court is DH&S' motion for summary judgment on plaintiffs' § 10(b) and Rule 10b-5 claims and DH&S' alternative motion for reinstatement of its contribution claims based on § 10(b) and Rule 10b-5. Any and all responses to these motions must be filed without exception no later than 5:00 p.m. on April 13, 1992. In light of these new motions, the court hereby RESCHEDULES the trial of this matter to commence on June 15, 1992, in Raleigh, North Carolina, with a pretrial conference to be scheduled accordingly.

This the 31st day of March, 1992.

/s/ Malcolm J. Howard
MALCOLM J. HOWARD
United States District Judge

At Greenville, NC
#19

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No. 93-154

IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

HERITAGE CAPITAL CORPORATION; NORTH RIVERSIDE VENTURE INC.; AND VENTURTECH II, LIMITED PARTNERSHIP,

Petitioners,

v.

DELOITTE HASKINS & SELLS,

Respondent.

Brief In Opposition To Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fourth Circuit

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QUESTIONS PRESENTED

1. IS AN AUDITOR'S REPORT TO A CLOSELY HELD COMPANY WHICH THE AUDITOR KNOWS AND INTENDS TO BE SOLELY FOR THE BENEFIT OF ITS CLIENT DEEMED TO BE A REPRESENTATION BY THE AUDITOR TO ALL POTENTIAL FUTURE INVESTORS OF THE AUDIT CLIENT FOR PURPOSES OF A CLAIM OF A PRIMARY VIOLATION UNDER SECTION 10(b)?

2. CAN THERE BE AIDING AND ABETTING LIABILITY UNDER SECTION 10(b) WHERE THE DEFENDANT OWED THE PLAINTIFF NO FIDUCIARY OR OTHER DUTY AND DID NOT TAKE ANY AFFIRMATIVE ACTION TO ASSIST THE ALLEGED PRIMARY VIOLATION?

LIST OF PARTIES TO THE PROCEEDINGS IN THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Deloitte Haskins & Sells is now known as Deloitte & Touche.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1993

HERITAGE CAPITAL CORPORATION; NORTH RIVERSIDE VENTURE INC.; and VENTURTECH II, LIMITED PARTNERSHIP,

Petitioners,

v.

DELOITTE HASKINS & SELLS,

Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Respondent Deloitte Haskins & Sells respectfully submits this Brief in Opposition to the Petition for a Writ of *Certiorari* to review the opinion of the United States Court of Appeals for the Fourth Circuit in *Heritage Capital Corporation; North Riverside Venture Inc.; and Venturtech II, Limited Partnership v. Deloitte Haskins & Sells*, (No. 92-1788, 4th Cir. 1993) because the Petition does not present any special and important reasons that warrant review by this Court.

STATEMENT OF THE CASE

Petitioners commenced this action by filing a complaint on December 31, 1988, in the United States District Court for the Eastern District of North Car-

olina. The complaint alleged that Respondent, Deloitte Haskins & Sells ("DH&S"), an independent accounting firm which had audited certain year-end financial statements prepared and issued by Learning Resources, Inc. ("LRI"), violated Section 12(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78(j)(b), and Rule 10b-5 promulgated thereunder (hereinafter referred to as the "Section 10(b) claims"). The complaint further alleged that DH&S was liable for violating Section 78A-56 of the North Carolina Securities Act and for common law fraud, breach of contract, professional negligence and breach of fiduciary duty.

On October 3, 1991, the District Court granted DH&S' motion for summary judgment on Petitioners' federal securities law claims, holding that (i) their Section 12(2) claims were time-barred by the statute of limitations set forth in Section 13 of the 1933 Act, and (ii) their Section 10(b) claims were time-barred by application of this Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson,* 111 S. Ct. 2773, 115 L.Ed.2d 321 (1991).

In January, 1992, DH&S moved for summary judgment on Petitioners' state law claims and Petitioners simultaneously moved for summary judgment with respect to their negligent misrepresentation and third party beneficiary breach of contract claims. In an order dated April 1, 1992, the District Court concluded that there were no genuine issues of material fact and granted DH&S' motion on all state law claims (and concomitantly denied Petitioners' motion), holding that:

1. DH&S did not owe a duty to Petitioners under North Carolina law governing Petitioners' neg-

ligent misrepresentation and third party beneficiary breach of contract claims because there was no evidence that DH&S intended or knew that its audit work would be relied upon by anyone other than its audit client, LRI. Appendix to Petition at 26a, 29a, 30a, 34a.

2. There was no evidence that DH&S engaged in any conduct with the scienter necessary to maintain an action for common law fraud under North Carolina law. Appendix to Petition at 35a.

3. There was no evidence that DH&S engaged in any conduct with an intent to influence or control Petitioners' investment decisions; consequently, there was no basis under North Carolina law to establish that DH&S owed Petitioners a fiduciary duty. Appendix to Petition at 37a.

4. There was no evidence that DH&S acted with a conscious intent or a specific motivation to assist an alleged fraud by LRI, and thus no evidence to maintain a claim against DH&S under North Carolina securities laws. Appendix to Petition at 39a.

Subsequent to the District Court's August 31, 1991 order granting DH&S' motion for summary judgment on Petitioners' federal securities claims, the United States Congress enacted legislation addressing the *Lampf* decision. *See* 15 U.S.C. §78aa-1. In response, the District Court reinstated the Section 10(b) claims on February 3, 1992. In March 1992, DH&S moved for summary judgment on these claims. DH&S' motion was granted by the District Court on May 15,

1992. The District Court, in addition to its findings set forth in its April 1st order, found that:

1. DH&S did not know at the time it prepared the audit reports that new investors, such as Petitioners, were being solicited. Appendix to Petition at 12a.
2. DH&S had no dealings or interaction with Petitioners, and did not in any way encourage or solicit Petitioners' investments in LRI. Appendix to Petition at 13a.
3. There was no evidence that DH&S had an intent to deceive, manipulate, or defraud anyone. Appendix to Petition at 14a.

Petitioners appealed to the United States Court of Appeals for the Fourth Circuit all of the District Court's summary judgment rulings in the April 1 and May 15, 1992 orders, with the exception of that portion of the April 1st order which held that DH&S did not owe Petitioners a fiduciary duty. In a *per curiam*, unpublished opinion dated April 30, 1993, the Fourth Circuit affirmed each of the District Court's rulings based on the District Court's opinions, and on May 21, 1993, issued its mandate. On July 29, 1993, Petitioners filed with this Court a petition for writ of *certiorari* solely with respect to the May 15th order and the affirmance by the Fourth Circuit of the grant of summary judgment as to Petitioners' Section 10(b) claims.

REASONS FOR DENYING THE WRIT

There are two fundamental reasons why the Petition does not present any special and important issues that warrant review by this Court. First,

Petitioners have not claimed that either the District Court or the Fourth Circuit misapplied this Court's decisions regarding the appropriate standard for granting summary judgment. Petitioners simply failed to establish the facts necessary to support the requisite elements of either a primary or an aiding and abetting claim under Section 10(b). Accordingly, Petitioners failed to convince either court below that there was a genuine issue of material fact with respect to any issue pertinent to DH&S' alleged liability under Section 10(b). The District Court, properly applying the summary judgment standards enunciated by this Court, therefore entered summary judgment in favor of DH&S on all claims. The Fourth Circuit, in a *per curiam*, unpublished opinion affirmed the judgments below based upon the District Court's findings of fact and conclusions of law. Petitioners' request to this Court to engage in a third review of the now worn factual record emphasizes the paucity of significant legal issues of this case.

Second, the courts below granted and upheld summary judgment on the basis of established precedents from this Court and applications of those precedents by the Circuit Courts. Petitioners' Section 10(b) claims against DH&S as a primary violator failed because there was no evidence that DH&S ever made any representation to Petitioners. The absence of this critical element compelled a finding that the primary Section 10(b) claims against DH&S were fatally deficient. Similarly, Petitioners' Section 10(b) claims based on aider and abettor liability failed because there was no evidence that DH&S owed Petitioners any duty or that DH&S possessed the requisite intent to deceive anyone. The established rule in the Circuit Courts is

that absent a duty to disclose or affirmative action to assist a primary violation, there can be no aider and abettor liability under Section 10(b) unless the defendant possessed a specific and conscious intent to deceive—*i.e.*, the defendant consciously assisted the alleged primary fraud—a level of scienter which the District Court and Fourth Circuit found to be utterly lacking here. Quite simply, the holdings of the District Court, as affirmed by the Fourth Circuit, were squarely based on this Court's Section 10(b) decisions and the consistent application of those decisions by the lower appellate courts.

Having found the existing law fatal to their claims, Petitioners ask this Court, in essence, to imply a right of action under Section 10(b) which would make an auditor the insurer of every investment which, at some time in the future, might be made in its audit client. This unprecedented and unworkable approach, which would expand the universe of potential plaintiffs, would not only expose professionals who have relationships with securities issuers to virtually unlimited liability, but ultimately would endanger the viability and advisability of professionals providing services to such issuers.[1] No authority, let alone a split of authority, exists in the Circuit Courts to support this expansive approach to Section 10(b).

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[1] The Seventh Circuit has discussed the undesirable economic effects of such open-ended liability:

> Duties to disclose or pay damages would raise the costs of all audits, as accountants increased fees to cover anticipated liabilities. Honest enterprises would pay these fees no less than dishonest (for until the audit ended, an accountant could not tell which was which). So firms would purchase less accounting ser-

In sum, this case presents no special and important reason why this Court should grant *certiorari*, since the District Court entered, and the Fourth Circuit affirmed, summary judgment in favor of DH&S based on the undisputed facts and a straightforward application of controlling law.

A. The Courts Below Properly Applied The Standard For Summary Judgment And Found That Petitioners Failed To Establish The Basic Elements Of Either A Primary Or Secondary Section 10(b) Claim.

The District Court correctly applied the standards for summary judgment established by this Court in reaching its conclusions that DH&S neither committed, nor aided and abetted, a primary violation under Section 10(b). Appendix to Petition at 21a-22a, citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986); and *Celotex Corp. v. Catrett*, 477 U.S. 317, 327 (1986). Petitioners now ask for a third review of the facts by this Court. That is not the purpose of *certiorari*.

Petitioners use a significant part of their Petition to state allegations which they say are derived from the summary judgment record. Petition at 3-9. What appears in the Petition, however, is not supported by the record. Rather, it is a discursive statement of arguments and contentions about the conclusions that they would like to have been drawn from undisputed facts that were before the District Court. They have

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vices, and investors in all firms would lose at both ends: the price would go up as the amount of oversight went down.

DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir.), *cert. denied*, 112 L.Ed.2d 312, 111 S. Ct. 347 (1990).

twice before made such arguments and contentions to no avail.[2] What the record actually shows is that Petitioners failed to present a genuine issue of material fact, and that the facts and evidence presented to the District Court when analyzed under well-established law were simply not sufficient to sustain any of their claims.

Specifically, the District Court found that DH&S did not make any representations to Petitioners. Appendix to Petition at 13a-14a, 30a. In fact, no DH&S employee ever conversed with, or delivered any documents to, any of the Petitioners, much less solicited any investments from Petitioners. Appendix to Petition at 13a, 26a.[3] The District Court found that the mere fact that the auditor was aware that its client might solicit investors in the future is not sufficient. Appendix to Petition at 25a-26a. Further, the

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[2] There are numerous other assertions in the Petition that are either out of context, incomplete, or which refer to allegations in the complaint. Petition at 6-9. Such assertions are beside the point as far as this Petition is concerned because they relate to claims that a duty was breached, rather than to the central issue of whether there was a duty in the first instance. Petitioners mix these allegations with the concepts of duty and recklessness in their Petition in an effort to support their theory that foreseeability establishes a primary duty under Section 10(b). That argument by Petitioners, which is wholly without support either legally or factually, is addressed in detail by DH&S in Section B of this brief.

[3] In this regard, the undisputed evidence before the District Court was that DH&S' audit reports on LRI's financial statements expressly stated that they were representations by DH&S only to "the Board of Directors and Shareholders" of LRI, and each of those reports was delivered directly and exclusively to LRI.

District Court concluded that DH&S did not intend its audit reports to be representations to anyone other than LRI. Appendix to Petition at 30a. The District Court determined that DH&S' audit reports on LRI's 1982, 1983, 1984, and 1985 financial statements were issued before DH&S had any knowledge of LRI's solicitation of Petitioners and could not have been intended to be representations by DH&S to them. Accordingly, DH&S could not have intended its 1982 through 1985 audit reports to be representations to Petitioners. Appendix to Petition at 29a-30a.

Petitioners contend here, as they did in the courts below, that DH&S' audit reports on LRI's 1982 through 1985 financial statements were intended to be representations to Petitioners based solely on the fact that a 1982 auditor's memorandum prepared by DH&S discussed the fact that a particular potential investor (Greylock Partners, which is not one of the Petitioners) would be relying on a particular review report (not an audit) of DH&S during negotiations with LRI concerning a particular investment proposal in 1982. The District Court rejected this argument, recognizing that a specific memo in 1982 concerning DH&S' preparation of a specific report for LRI, for use by a specifically identified potential investor in connection with a particular investment transaction, is not sufficient evidence that DH&S intended future audit reports to be representations to "*any* potential venture capital investor at *any* future time," (Appendix to Petition at 26a, emphasis in original of District Court's order of April 1, 1992), including the Petitioners four or five years later.[4]

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[4] In fact, the opposite conclusion can be drawn. When DH&S

As to the 1986 report, two of the Petitioners, North Riverside and Heritage, have conceded that they could not have relied on DH&S' audit report on LRI's 1986 financial statements. Petition at 4. Both entities invested in LRI on December 31, 1986, three months prior to the issuance of that audit report. Thus, any reliance by them on DH&S' 1986 report was chronologically impossible. Petitioner Venturtech, which invested in LRI in June, 1987, after the issuance of DH&S' audit report on LRI's 1986 financial statements, does not make this concession. However, the District Court held that DH&S had no contact with Venturtech whatsoever and neither knew nor intended that its audit report on LRI's 1986 financial statements would be used in connection with any investment, or that it would be a representation to Venturtech. Appendix to Petition at 33a. Venturtech attempts to dispute this factual ruling by referring to four documents in the record, but has twice failed to convince a court that these documents raise any genuine issue of a material fact regarding whether DH&S knew of a pending investment in LRI by Venturtech and intended its 1986 audit report to constitute a representation to Venturtech in connection with Venturtech's investment decision.[5]

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rendered services specifically for utilization by LRI in connection with an investment, LRI and DH&S expressly noted it in their engagement agreement. The absence of such an acknowledgment between LRI and DH&S with respect to any of the audits complained of by Petitioners refutes their contention that it was foreseeable, let alone intended, by DH&S that any of its audit reports would be relied upon by Petitioners in connection with their investments in LRI.

[5] The District Court held just the contrary. Rather than establishing that DH&S knew of a pending investment by Ven-

Recognizing that there is no evidence that DH&S intended its reports to be representations to Petitioners, Petitioners nevertheless suggest that such audit reports should be deemed to be representations by DH&S to Petitioners because "Deloitte knew of LRI's capital raising efforts" and therefore should have foreseen that investors like Petitioners would rely on DH&S' audit report in making their investment decisions. Petition at 5. Petitioners further suggest that the District Court (i) ignored this evidence of "Deloitte's knowledge of LRI's capital raising efforts" in finding DH&S owed no duty to Petitioners, and (ii) essentially imposed a privity standard on an accountant's duty under federal securities laws. Petition at 18. Both of these contentions are incorrect.

A review of the record belies Petitioners' suggestions that the District Court overlooked evidence or that it established a privity standard. First, the District Court examined and rejected the concept that mere knowledge by an auditor that there might be future investments is enough. Appendix to Petition at 25a-27a. This finding is in accord with established authority. *See Frymire-Bernati v. KPMG Peat Marwick*,

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turtech in LRI in June, 1987, three of these documents establish that DH&S knew only that there were proposed investments in LRI which would close on December 31, 1986, *several months before* the issuance of its audit report on LRI's 1986 financial statements. Appendix to Petition at 33a. Petitioners did not make any argument to the District Court regarding the fourth document, LRI's March 1993 board minutes. Moreover, it is undisputed that Petitioners produced these minutes from their own files. These minutes were not present in DH&S' files nor do any of DH&S' audit workpapers or notes make any reference to the issues discussed in these minutes.

___ F.2d ___ , 1993 U.S. App. LEXIS 19657 (7th Cir. 1993). Second, the District Court reviewed in detail the evidence Petitioners presented concerning previous venture capital investments in LRI and concluded that—with the exception of a 1982 review report prepared with specific knowledge by DH&S that a particular investor, Greylock Partners, would rely on the review report in making an investment decision in 1982—"the record contains no evidence that DH&S knew that the financial statements prepared by it were distributed to, or used by, venture capital investors." Appendix to Petition at 27a.[6]

Simply put, what the District Court found was that there was no evidence that DH&S knew that its audit reports were to be distributed to or used by venture capital investors, participated in any LRI securities offering, made any representations regarding any such offering, communicated in any way with any of Petitioners in connection with the making of their

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[6] Petitioners also assert a theory of liability based upon their contention that DH&S failed to obtain management representation letters during the 1985 and 1986 audits. Petitioners argue that such alleged failures require a finding, as a matter of law, that LRI's financial statements be deemed to be representations of DH&S rather than LRI, despite the fact that it was LRI that later furnished its 1985 financial statements to Petitioners and its 1986 financial statements to Venturtech without the knowledge or participation of DH&S. While DH&S does not agree with Petitioners' characterization of the evidence, the particular facts are not germane to the Petition. Petitioners made their assertion in the District Court and in the Circuit Court without success. Petitioners offer no authority to support the theory. There is no such authority. Moreover, as set forth in detail above, the undisputed facts and the conclusions of the District Court show that there is no logic to the Petitioners' contention.

investment decisions, or possessed an intent to deceive anyone. Appendix to Petition at 12a-14a, 25a-27a. Section 10(b) does not impose any duty on DH&S under these circumstances that would give rise to either primary or aiding and abetting liability.

B. For Purposes Of A Primary Section 10(b) Claim, There Is No Authority, Much Less A Split Of Authority, As To Petitioners' Proposition That A Report Issued By An Auditor To Its Audit Client Is Deemed To Be A Representation Made To All Potential Future Investors.

Petitioners assert that if an auditor knows that its audit client may at some unspecified time in the future have a need for investment capital, then the auditor "should know" that the unknown future investors will rely on the audit report. According to Petitioners, it therefore follows that an audit report issued solely to the audit client, perhaps years before any actual investor appears, should *ipso facto* be deemed an affirmative representation by the auditor to the investor sufficient to create liability under Section 10(b). Petition at 18-19. The District Court properly rejected this theory. Appendix to Petition at 25a-27a. Petitioners reason for advancing this theory of virtually unlimited liability is obvious. Petitioners must circumvent the District Court's holding that DH&S made no representations to them and did not intend to deceive Petitioners or anyone else. The mere fact that an auditor knows that companies may in the future need investment capital (which Petitioners argue makes foreseeable both the existence of such investors and their reliance on the auditor's report) has not been determined by this Court or any Circuit Court to constitute the predicate for imposing liability

under Section 10(b). Thus, Petitioners' contentions do not present for review either a split among the Circuit Courts or a matter which has not been settled by this Court.

Rather than cite any cases in support of this attenuated "foreseeability" theory, and without any logical connection to their arguments, Petitioners leap to cases applying the recklessness standard to Section 10(b) claims involving affirmative representations. Indeed, Petitioners have admitted the critical fact which makes each of their cases inapposite here. They concede that "Deloitte did not solicit [Petitioners'] investments in LRI, nor did it help create a formal, published prospectus including its name and work." Petition at 20. This is a dispositive concession, particularly in light of the District Court's finding that DH&S did not have any communication with any of the Petitioners. Each of Petitioners' "authorities" involves a claim that a defendant either (i) prepared a report specifically for inclusion in an offering document directed to the plaintiff, such as a prospectus, or (ii) participated in soliciting the plaintiff's investment.

For example, in *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987), the plaintiff complained of an audit report which the auditor knew would be included in a prospectus to be directed to the plaintiff. In *Akin v. Q-L Investing, Inc.*, 959 F.2d 521 (5th Cir. 1992), the allegations were that the audit report was prepared expressly for distribution in a private placement memorandum to be directed to the plaintiff. In *Wiley v. Hughes Capital Corporation*, 746 F. Supp. 1264 (D.N.J. 1990), the plaintiff asserted that the auditor

prepared a report specifically for inclusion in a prospectus to be directed to the plaintiff. In *Ades v. Deloitte & Touche*, 799 F. Supp. 1493, 1495 (S.D.N.Y. 1992) (which was a motion to dismiss), the allegations before the court were that the auditor "consented to use of its . . . opinion . . . in various filings with the Securities and Exchange Commission." In *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314 (S.D.N.Y. 1982), the audit client was a mutual fund, which by law must publish a prospectus containing audited financial statements.

In each of these cases, there were allegations that the defendant-auditor intended to make an affirmative representation to the plaintiff. Thus, the plaintiff's reliance on the audit report was not merely 'foreseeable,' as Petitioners contend.[7] It was intended. That

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[7] Even under Petitioners' theory of "foreseeability," Petitioners' claims would fail because the District Court found that DH&S did not know of any distribution of its reports to, or use by, venture capital investors. Appendix to Petition at 27a. The Seventh Circuit has recently analyzed a similar contention in *Frymire-Brinati v. KPMG Peat Marwick*, ___ F.2d ___, 1993 U.S. App. LEXIS 19657 (7th Cir. 1993). There, the court focused on the "in connection with" element of a Section 10(b) claim against an auditor. Vacating a jury verdict and dismissing the Section 10(b) claim against the auditor, the Court held, *inter alia:*

> Any auditor's opinion might be used in connection with the sale of securities, but most financial statements serve to assist existing investors who seek to know the status of their firm and desire to monitor the managers. To find the "connection" just because the managers, unbeknownst to the auditors, show the financial statements to some potential investor would abolish the requirement that the defendant's acts oc-

is quite different from this case where the District Court found that DH&S did not intend for its reports to be for the benefit of anyone other than its client (Appendix to Petition at 30a) and, moreover, did not even know that its reports were distributed to, or used by, any investors (other than a review report specifically for Greylock in 1982). Appendix to Petition at 27a.

The other cases cited by Petitioners as supporting their "foreseeability" theory involved information which, although not included in an offering document, was specifically intended by the defendant to be a representation to the plaintiff. For example, in *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982), the defendant accountants prepared a tax opinion for the specific purpose of its distribution by the client to potential investors. In *Sioux, Ltd. Securities Litigation v. Coopers & Lybrand*, 914 F.2d 61 (5th Cir. 1990), the auditing firm's partner in charge of the audit personally represented to investors that a contingent liability of the audit client would have no effect on the client's financial statements.[8] Thus, there is no ques-

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cur "in connection with" the purchase or sale of securities.

As in *Frymire-Brinati*, the District Court concluded that the ever present possibility of future investors is not enough to impose liability on an auditor. Appendix to Petition at 25a-26a, 31a.

[8] Petitioners' discussion of this case, however, does not reveal this critical fact, which is set out in a prior opinion in the same litigation. *See Sioux, Ltd. Securities Litigation v. Coopers & Lybrand*, 901 F.2d 51, 53 (5th Cir. 1990)("The plaintiffs . . . contend that Coopers & Lybrand's partner in charge of the audit

tion that each of these cases was predicated on the existence of an affirmative representation directly by the auditor to the investor.[9]

In stark contrast to the facts of each case cited by Petitioners, LRI was a closely held, non-reporting corporation. Its securities were never registered under the 1933 Act, or publicly offered, issued, or traded. Neither LRI's financial statements nor any related audit reports, including DH&S' audit reports complained of by Petitioners, were ever included in any registration statement, prospectus, offering circular, or private placement memorandum. Further, DH&S did not communicate with Petitioners and did not solicit Petitioners' investments in LRI. *See* Petition at 20. The District Court therefore found that DH&S made no representation to any of Petitioners.[10]

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assured them that the events [pertaining to the contingent liability] did not affect the validity of the . . . audit.").

[9] In discussing these cases, DH&S is not addressing whether the courts ruled correctly regarding the ultimate issues before them, but rather that the allegations and facts before these courts were distinguishable from those of the present case where the District Court held, and the Fourth Circuit affirmed, that there was no evidence that DH&S had any contact with Petitioners or consented to the use of its audit reports in any materials which it knew would be provided to Petitioners.

[10] The District Court found that at the time DH&S issued its audit report on the 1985 financial statements, dated April 11, 1985, it did not know about the December 1986 investment or its solicitation. The court similarly found that at the time DH&S issued its 1986 audit report dated March 20, 1987, it did not have any knowledge of the Venturtech investment which was made in June 1987, or its solicitation. Petition at 33a. Petitioners do not dispute any of these findings.

Thus, there is simply no Circuit Court authority to support Petitioners' theory that an audit report issued only to the audit client is deemed to be a representation by the auditor to all potential future investors in the audit client. Common sense compels the conclusion that an auditor must intend to make a representation to a potential investor before it can intend to mislead or deceive the investor by that representation. Indeed, the cases cited by Petitioners confirm this logic; each addressed primary liability claims involving an intended representation by the defendant to the plaintiff.

The only other authority Petitioners cite to support their foreseeability theory is dicta from *United States v. Arthur Young*, 465 U.S. 805 (1984), which Petitioners cite woefully out of context. In *Arthur Young*, the sole issue before this Court was the scope of the subpoena power of the Internal Revenue Service ("IRS") under 26 U.S.C. §7604. *Id.* at 807. The accounting firm was not a party to the original action and the IRS asserted no misrepresentation claims against it. The action involved tax, not Section 10(b), claims against the accountant's client. *Id.* at 817-18. This Court held that the accountant's workpapers were (i) relevant to issues raised by the IRS and (ii) not protected from discovery by any privilege. Thus, contrary to Petitioners' assertion, this Court's decision in *Arthur Young* was not the genesis of any new "watch dog" role for accountants, and in no manner held, or even implied, that accountants have a universal fiduciary duty to every person to whom its audit client provides its financial statements.[11]

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[11] Not only is Petitioners' assertion that public policy favors

C. There Is No Split Of Authority On The Elements Of An Aiding And Abetting Liability Claim As Presented By The Facts Of This Case.

The Petitioners also seek review of the decisions below with respect to dismissal of Petitioners' aiding and abetting claims under Section 10(b). The District Court granted DH&S summary judgment on those claims based upon its findings that DH&S had no fiduciary or special duty to the Petitioners (which Petitioners did not appeal to the Fourth Circuit), did not take any affirmative actions to assist the alleged fraud by LRI, and harbored no intent to deceive the Petitioners or anyone else. Struggling under the weight of those findings, the Petitioners seek to have this Court decide that a claim of some form of reckless conduct, without more, it sufficient to impose aiding and abetting liability under Section 10(b).[12] However, neither this Court nor any Circuit Court has held that reckless conduct alone, without either a fiduciary or other special duty owed by the defendant to the plaintiff or some affirmative action by the defendant to assist the alleged fraud, suffices

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placing "watch dog" responsibilities on auditors without authoritative support, it has already been considered and rejected by the Fourth Circuit, and other courts. *See, e.g., Schatz v. Rosenberg*, 943 F.2d 485, 493-494 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992); and *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 498 U.S. 941, 111 S. Ct. 347, 112 L.Ed.2d 312 (1990).

[12] It is virtually impossible to determine where Petitioners' arguments relating to primary liability stop and its arguments relating to aiding and abetting start. Petitioners mix concepts and allegations in a fashion that blurs the essential distinctions between these two concepts of liability.

to impose liability for aiding and abetting under Section 10(b).[13]

This Court has twice held that Section 10(b) does not in and of itself impose a duty to disclose a primary violation of another. Instead, such a duty, if it exists, "arises from a relationship between the parties." *Dirks v. United States*, 463 U.S. 616, 658 (1983). More particularly, such a duty of disclosure exists if there is "a fiduciary or other similar relation of trust and confidence" between the plaintiff and the defendant. *Chiarella v. United States*, 445 U.S. 222, 228 (1980). In other words, the federal "securities laws do not impose a general duty to speak . . . these duties must be found in state law." *DiLeo v. Ernst & Young*, 901 F.2d 624, 628 (7th Cir. 1990), citing *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

The Fourth Circuit, in *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 1475 (1992), expressly followed these precedents in holding that Section 10(b) does not impose a duty to disclose the misrepresentations of another unless there is a "fiduciary or other confidential relationship" between the plaintiff and the defendant. *Schatz*, 943 F.2d at 490. *See also Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1125 (7th Cir. 1990), *cert. denied*, 113 L.Ed.2d

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[13] This Court has accepted for review the question of whether there even exists a private cause of action for aiding and abetting under Section 10(b) by issuing a writ of *certiorari* in *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891 (10th Cir. 1992), *cert. granted sub nom. Central Bank of Denver v. First Interstate Bank of Denver, N.A.*, 1992 WL 353224 (U.S.), and if such a cause of action exists, whether recklessness is an appropriate standard upon which to predicate aider and abettor liability under Section 10(b).

250, 111 S. Ct. 1317 (1991) ("[G]eneral duties to speak do not find their source in securities laws, . . . but instead 'must come from a *fiduciary relation* outside securities laws.'"—emphasis added), quoting *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) (emphasis added).

In the present case, the District Court found as a matter of law that there was no fiduciary or other special relationship between DH&S and Petitioners. Appendix to Petition at 13a. Petitioners did not challenge that ruling on appeal to the Fourth Circuit. In the absence of a fiduciary relationship between DH&S and Petitioners, the rulings of *Dirks*, *Chiarella*, and *Schatz* compel the conclusion that DH&S owed no duty to Petitioners.

1. Absent A Duty Of Disclosure, Petitioners Had To Prove That DH&S Acted With High Conscious Intent And A Specific Motivation To Aid A Fraud In Order To Prevail On Their Aiding And Abetting Claims.

The Fourth Circuit has held that in the absence of a duty to disclose, the level of scienter necessary to impose aiding and abetting liability under Section 10(b) is "high conscious intent" and a "conscious and specific motivation" to assist the fraud. *Schatz*, 943 F.2d at 496, citing *IIT v. Cornfeld*, 619 F.2d 909, 925 (2d Cir. 1980); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975); and *Martin v. Pepsi Cola Bottling Co.*, 639 F. Supp. 931, 934-45 (D. Md. 1986). The trial court concluded that DH&S had no such intent, finding that there was no evidence "from which a juror could conclude that DH&S deliberately shut its eyes to the truth [or] intentionally failed to conduct a proper audit." Appendix to Petition at 14a.

Contrary to Petitioners' suggestion, the rulings below were squarely within the holdings of the Circuit Courts which have addressed the situation presented by the case at bar—*i.e.*, allegations of a failure to disclose, but no finding of a fiduciary or other special relationship. *See Cleary v. Perfectune, Inc.*, 700 F.2d774, 777, 779 (1st Cir. 1983)(noting that "courts generally have held that in the absence of a duty of disclosure, a defendant should be held liable as an aider and abettor only if plaintiff proves the defendant had actual knowledge of the improper activity of the primary violator and his role in the activity," and dismissing the plaintiffs' aider and abettor claim because they "failed to produce any evidence from which it might be inferred that defendants' inaction was consciously intended to further the [primary violator's] allegedly fraudulent activity"); *IIT v. Cornfeld*, 619 F.2d 909, 925 (2d Cir. 1980)("When it is impossible to find a duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high 'conscious intent' variety can be proved."); *Monsen v. Consol, Dressed v. Beef Co., Inc.*, 579 F.2d 793, 799 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978)(if there is no duty, inaction may provide a predicate of liability only where "plaintiff demonstrates that the aider-abetter consciously intended to assist in the perpetration of a wrongful act"); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975)("When it is impossible to find any duty of disclosure, an alleged aider-abetter should be found liable only if scienter of the high conscious intent variety can be proved."); *Metge v. Baehler*, 762 F.2d 621, 625 (8th Cir. 1985), *cert. denied*, 474 U.S. 1072, 88 L.Ed.2d 804, 106 S.Ct. 832 (1986)("Simply put, in the absence of a duty to act or disclose, an aider-abettor case

predicated on inaction of the secondary party must meet a high standard of intent" *i.e.*, "high 'conscious intent'."); *Harmsen v. Smith*, 693 F.2d 932, 934 (9th Cir. 1982), *cert. denied sub nom. Smith v. Harmsen*, 464 U.S. 822, 78 L.Ed.2d 97, 104 S. Ct. 89 (1983)(plaintiff must prove "*knowledge* by the alleged aider and abetter of the wrong and his or her role in furthering it"); *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 989 (10th Cir. 1992)("if there is no fiduciary duty . . . the scienter requirement increases so that [plaintiff] needs to show that [defendant] acted with actual intent."); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988), *cert. denied*, 490 U.S. 1091 (1989)("a defendant who is not under any duty to disclose can be found liable only if he acts with a high degree of scienter, that is, acts with a 'conscious intent' to aid the fraud."); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35-36 (D.C. Cir. 1987) ("in the absence of a duty to disclose, there is no liability unless the defendant 'manifests a conscious intention to further the principal violation."); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) (plaintiff must show that the alleged aider and abetter "committed one of the 'manipulative or deceptive' acts").

The rationale supporting the requirement that, absent a duty of disclosure, a high level of scienter must be shown was clearly stated by the Third Circuit:

> [K]nowledge of the underlying violation is a critical element of proof in aiding and abetting liability, for without this requirement, . . . [professional service] organizations would be virtual insurers of their customers against security law violations. Culpability of some

> sort is necessary to justify punishment of a secondary actor, and mere unknowing participation in another's violation is an improper predicate to liability.

Monsen v. Consol. Dressed Beef Co., Inc., 579 F.2d 793, 799 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978).

The *only* Circuit Court authority which Petitioners even contend holds that recklessness will satisfy the scienter requirement for aider and abettor liability under circumstances similar to the case at bar is *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301 (9th Cir. 1982). *See* Petition at 15. This reliance is misplaced. The excerpt from *Admiralty Fund* quoted by Petitioners is a general statement made without any discussion of the duty issue.[14] In fact, there is no discussion whatsoever in the *Admiralty Fund* decision about whether the alleged aider and abettor did, or did not, have a duty relationship with the plaintiff. Moreover, subsequent to *Admiralty Fund*, the Ninth Circuit held that a plaintiff must prove "*knowledge* by the alleged aider and abettor of the wrong and his or her role in furthering it." *See, Harmsen v. Smith*, 693 F.2d 932, 934 (9th Cir. 1982) (emphasis in original), citing *IIT v. Cornfeld, Monsen*

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[14] It also should be noted that the *Admiralty Fund* court cites in support of the quoted statement the Fifth Circuit's decision in *Woodward v. Metro Bank of Dallas*, a case which expressly held (and is often cited for) the following:

> When it is impossible to find any duty of disclosure, an alleged aider-abettor should be found liable only if scienter of the high "conscious intent" variety can be proved.

Woodward, 522 F.2d at 97.

v. Consol. Dressed v. Beef Co., Inc., Woodward v. Metro Bank of Dallas—all of which stand for the proposition that absent a fiduciary duty, a plaintiff must show that the alleged aider and abettor acted with conscious awareness of the fraud.

In the present case, the District Court in its April 1st order held that:

> The plaintiffs have neither alleged nor proven that DH&S possessed such a state of mind. The court cannot find in the record, and the plaintiffs have not presented, any evidence indicating that DH&S conducted its audits with a "high conscious intent" to aid a securities violation.

Appendix to Petition at 39a. It went on to state in its May 15th order that "there is [no] evidence from which a juror could conclude that DH&S deliberately shut its eyes to the truth and intentionally failed to conduct a proper audit." Appendix to Petition at 14a. Simply put, the District Court correctly held, and the Fourth Circuit has affirmed, that without any evidence of a conscious intent by DH&S to aid an alleged fraud by LRI, summary judgment in favor of DH&S on Petitioners' secondary Section 10(b) claims was compelled by the decisional law. There is no split of authority, as Petitioners suggest, which would provide a basis for the grant of a writ of *certiorari*.

Petitioners, unable to come forward with any reason why this Court should grant *certiorari*, attempt to bootstrap themselves into *certiorari* by invoking another case before this Court. Petitioners assert that *First Interstate Bank of Denver, N.A. v. Pring*, 969 F.2d 891 (10th Cir. 1992), *cert. granted sub nom. Central Bank of Denver v. First Interstate Bank of Den-*

ver, N.A., 1992 WL 353244 (U.S.), addresses "essentially the same arguments made by Deloitte—that recklessness is not sufficient scienter when there is no duty to disclose." Petition at 16. However, the allegations in *Pring* are fundamentally different from the present case.

2. In *Pring*, The Allegations Of Secondary Liability Under Section 10(b) Are Fundamentally Different Than Petitioners' Allegations In The Present Case.

In *Pring*, the plaintiffs sought recovery of losses incurred upon the default of development bonds which the plaintiffs had purchased. They asserted Section 10(b) aiding and abetting claims against Pring, a principal of the developer, and against the indenture trustee for the development bonds. The plaintiffs alleged that Pring remained silent with respect to the alleged fraud with an "actual intent to aid the primary violation." *Id.* at 899. In the present case, the District Court found no evidence that DH&S intended to deceive anyone or intended to aid anyone else's deception. Appendix to Petition at 14a, 39a. Thus, the claims against Pring are not relevant here.

The plaintiffs in *Pring* also alleged that the indenture trustee aided and abetted the alleged primary Section 10(b) violation. Specifically, they asserted that the trustee "assisted the primary violation by *affirmative action*" by agreeing to delay an independent review of an appraisal of the property being developed with the bond proceeds. *Id.* at 902 (emphasis in original). Therefore, the issue before the Tenth Circuit was: "[W]hen an alleged aider and abettor owes no duty to plaintiffs, *but takes affirmative action that*

assists the primary violation,[15] does recklessness satisfy the scienter requirement for aiding and abetting liability?" *Id.* at 902 (emphasis added). The District Court found, and the Fourth Circuit affirmed, that there was no evidence of any such affirmative action by DH&S in this case. Appendix to Petition at 39a.

The Tenth Circuit's opinion in *Pring* recites various cases demonstrating the type of affirmative assistance which may be actionable under Section 10(b). Each example was predicated on a direct interaction between the plaintiff and the alleged aider and abettor. *See, e.g., Levine v. Diamanthuset, Inc.*, 950 F.2d 1478 (9th Cir. 1991)(defendant trust company interacted directly with defrauded investors by, *inter alia*, making representations and issuing confirmations); and *FDIC v. First Interstate Bank*, 885 F.2d 423 (8th Cir. 1989)(defendant bank processed funds and administered accounts of plaintiffs). Here, Petitioners concede

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[15] Consistent with the Fourth Circuit's holding in *Schatz* and the holdings of the other Circuit Courts discussed above, the Tenth Circuit recognizes that in order to maintain a claim for aiding and abetting liability under Section 10(b), the plaintiff must show that the alleged aider and abettor provided substantial assistance with respect to the primary violation, not simply to the person committing the violation. As explained by the Fourth Circuit in *Schatz*:

> [T]he "substantial assistance element requires that a lawyer must actively participate in soliciting sales or negotiating terms of the deal on behalf of the client to have "substantially assisted" a securities violation. In other words, a plaintiff must prove that a defendant rendered "substantial assistance" *to the primary securities violation*, not merely *to the person* committing the violation.

Schatz, 943 F.2d at 497 (emphasis added).

that DH&S did not solicit or negotiate the sale of any LRI securities to them. Appendix to Petition at 13a. Indeed, there was no communication of any nature between DH&S and Petitioners. *Id.* Therefore, the issues presented for review in *Pring*, and the cases cited therein with respect to "affirmative assistance," are inapposite here.

CONCLUSION

The grant of summary judgment by the District Court and the affirmance by the Fourth Circuit are consistent with the decisions of this Court and well supported by the record. There is no special and important reason for this Court to consider and no purpose would be served by this Court's review of the opinions below. The Petition for a Writ of *Certiorari* should therefore be denied.

September 1, 1993

Respectfully submitted,

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